



The Impact of Fiscal Policy on Foreign Direct Investments in Albania

Dr. Robert Çelo*, and Msc. Rovená Bega

Finance Accounting Department, “Eqrem Çabej” University, Gjirokaster, Albania

Abstract

Fiscal policy plays an important role in shaping the economic climate of a country, especially when it comes to attracting foreign direct investment. Fiscal policy, which includes the tax system and public spending, is a key factor in creating a favorable environment for foreign investors. In recent years, Albania has implemented reforms that have reduced the rates of profit tax and personal income tax, making the tax system more attractive to investors. These measures, in addition to fiscal incentives for strategic sectors such as energy and tourism, have improved the business climate. Macroeconomic stability is another critical aspect, as a stable economy with low inflation and political certainty helps boost investor confidence. A developed infrastructure and high-quality public services also contribute to the attraction of investments. However, Albania continues to face challenges such as corruption and the need to diversify investment sources. Corruption can negatively affect investor perception and increase operating costs. To maximize its potential, Albania must address these challenges and continue to improve its infrastructure and tax administration. This analysis emphasizes the importance of a stable and predictable fiscal policy to increase foreign direct investment flows and ensure sustainable economic development in the country.

Keywords: Fiscal Policy, Direct Investments, Foreign Investments, Tax Administration, Fiscal Facilities

1. Introduction

2.2. Social Equity and Access to the Creative Industries

This paper investigates the impact of fiscal policy on Foreign Direct Investment (FDI) inflows in Albania, focusing on the effects of tax rates, government spending, and macroeconomic stability on investor decisions. The goal is to assess whether Albania's fiscal policies are effective in attracting foreign investments and to explore ways to improve the country's competitiveness. In an increasingly competitive world, countries strive to attract foreign investors through a variety of measures and policies that promote economic growth and sustainable development. The impact of fiscal policy on FDI is sensitive and multifaceted, including aspects such as taxes, subsidies and public spending. In Albania,

since the overthrow of the communist regime in the 90s, a continuous effort has been made to attract foreign investments. Albanian governments have implemented various fiscal reforms to create a more favorable environment for investors. These reforms include lowering income tax rates and other taxes, as well as providing incentives to certain sectors. Fiscal policy aimed at attracting FDI is often a combination of tax breaks and other measures that encourage investment growth, such as improving infrastructure and creating favorable business conditions. Another important aspect is how fiscal policy can affect investor confidence. A transparent and stable fiscal system is essential to help investors feel confident in their decisions. Furthermore, a clear and predictable fiscal policy helps to minimize the risks and uncertainty associated with investments. In this context, Albania has made efforts to improve its fiscal climate and increase transparency in its administration.

Despite positive efforts, Albania also faces numerous challenges. These include corruption, excessive bureaucracy and a judicial system that often does not provide sufficient guarantees for the protection of investments. These factors can negatively affect investors' decisions and attract FDI. Therefore, it is necessary that the fiscal policy is accompanied by other structural reforms that address these problems.

In conclusion, the impact of fiscal policy on foreign direct investment in Albania is a complex and multidimensional topic. As the government continues to improve fiscal measures to attract investors, it is important to ensure a stable and attractive investment environment. Only through an integrated and sustainable approach can sustainable economic growth be achieved in the country.

2. Literature Review

Foreign Direct Investment (FDI) has been a central topic in economic studies, particularly regarding its relationship with fiscal policy and its effects on economic growth. A substantial body of literature has examined the various factors that attract FDI, including fiscal policy measures, taxation systems, government spending, infrastructure quality, and political stability. This literature review explores the role of fiscal policy in shaping FDI inflows, particularly in the context of Albania, and outlines key factors such as tax policies, government spending, infrastructure, macroeconomic stability, and political governance. By examining how these factors intersect with Albania's specific context, we can better understand the opportunities and challenges the country faces in attracting FDI.

One of the most critical fiscal policies influencing FDI inflows is the corporate tax rate. Numerous studies have shown that lower corporate tax rates are often associated with increased FDI, as they reduce the overall cost of investment for foreign firms. Blonigen (2005) suggests that tax rates can significantly impact the attractiveness of a country for foreign investors. Albania's tax reforms, including the reduction of corporate tax rates and the introduction of incentives for strategic sectors, have been integral to enhancing the business climate and attracting foreign investments (Bank of Albania, 2023).

However, tax policy alone is not sufficient. Studies by Asiedu (2006) emphasize that tax systems that are transparent and stable are key drivers of FDI. Countries with simplified compliance procedures and predictable tax policies tend to attract more foreign investments. Albania offers competitive tax rates, but challenges such as tax evasion and informal economic activities remain barriers to fully capitalizing on these fiscal incentives (OECD, 2018). Strengthening the credibility and efficiency of Albania's tax administration could significantly enhance its attractiveness as an investment destination.

Fiscal incentives, such as tax cuts, are not the only way fiscal policy can influence FDI. Effective government spending on infrastructure is another important factor. Studies by de Mello (1999) and Alfaro et al. (2004) highlight the role of infrastructure investment in reducing operational costs for foreign firms. Sectors such as transportation, energy, and communication are especially critical in this regard. Albania's ongoing efforts to improve infrastructure, reduce bureaucratic obstacles, and simplify administrative processes complement its fiscal reforms, contributing to the country's growing appeal as an investment destination.

In particular, Albania has made substantial investments in energy infrastructure and transportation networks, which are crucial for facilitating foreign business operations. However, these improvements need to be sustained and expanded to match the growing demands of foreign investors.

Macroeconomic stability is another critical determinant of FDI. Low inflation rates, a stable currency, and overall economic stability reduce risks for investors, particularly when making long-term commitments. According to Rodrik (2008), countries with stable macroeconomic environments tend to attract more FDI, as investors seek predictable returns. Borensztein et al. (1998) further emphasize that emerging economies with stable macroeconomic conditions create a more attractive environment for foreign investments.

Albania, through a series of economic reforms initiated in the 2000s, has worked toward achieving greater macroeconomic stability. This progress has been important in boosting investor confidence. However, while Albania has made strides in stabilizing its economy, the country must continue to focus on maintaining low inflation, stable exchange rates, and fiscal discipline to keep enhancing its attractiveness to foreign investors.

Political stability and governance are crucial in creating an environment conducive to FDI. Hallward-Driemeier (2003) argues that political stability reduces uncertainty for investors. In addition, good governance, including transparency, rule of law, and reduced corruption, fosters a business-friendly environment. Studies by Campos & Kinoshita (2003) support this claim, showing that improved governance indicators are associated with increased FDI inflows.

Albania has made significant strides in political and economic governance, especially since its transition to a market economy. Nevertheless, corruption and bureaucratic inefficiencies continue to be significant challenges. As noted by the OECD (2022), Albania must continue to tackle these issues to further enhance investor confidence and fully capitalize on its FDI potential. Strengthening the legal framework and improving public sector transparency will be key to attracting more foreign investment.

Albania's experience with FDI has been mixed. FDI has played a significant role in the development of sectors such as energy, construction, and real estate (Bank of Albania, 2023). However, the country has faced several challenges, including corruption, complex administrative procedures, and inefficiencies in the legal system. These barriers hinder the full potential of FDI. Albania's efforts to reform its legal framework and combat corruption are vital steps in enhancing its competitiveness as an investment destination (World Bank, 2020).

Despite these challenges, FDI has had a notable impact on Albania's economic development. The growth in sectors like energy and real estate highlights the potential for FDI to contribute to sustainable economic growth, provided that Albania continues to address the barriers to investment.

The literature also sheds light on broader regional trends that can inform Albania's FDI strategy. Sapienza (2010) explored the relationship between FDI and economic growth in Central, Eastern, and Southern Europe, offering valuable insights into the factors that shape FDI inflows. His study found that countries with favorable fiscal environments tend to attract higher levels of investment. Albania's fiscal reforms, while competitive, still face challenges in implementation that need to be addressed to keep pace with neighboring countries.

Tulu (2020) examined how federalism and democratic institutions impact FDI inflows, suggesting that stable democratic governance structures complement fiscal incentives in attracting foreign investment. Albania's progress in consolidating its democratic institutions could help strengthen its position as a leading investment destination in the region.

3. Methodology

The methodology will guide the empirical analysis of the relationship between fiscal policy and FDI in Albania. Below is a potential approach:

1. Data Collection:
 - FDI Data: Data on Foreign Direct Investment in Albania, typically obtained from the Bank of Albania, the Ministry of Finance, or international databases such as the UNCTAD or World Bank.
 - Fiscal Policy Data: Collect data on key fiscal indicators such as corporate tax rates, fiscal deficit/surplus, government spending, and public debt. This can be sourced from government reports or international organizations (e.g., IMF, World Bank).
 - Macroeconomic Indicators: GDP growth, inflation rates, unemployment, and exchange rates as control variables, as they could also influence FDI.
2. Model Specification: To assess the relationship between fiscal policy and FDI, one can specify an econometric model. A potential model could be a multiple linear regression or panel data analysis:

$$FDI_{it} = \alpha + \beta_1 * TaxRate_{it} + \beta_2 * GovSpending_{it} + \beta_3 * GovDebt_{it} + \beta_4 * GDPGrowth_{it} + \epsilon_{it}$$

- Where:
 - FDI_{it} is the Foreign Direct Investment inflow into Albania in year t (or for a specific industry or sector).
 - $TaxRate_{it}$, $GovSpending_{it}$, $GovDebt_{it}$ are fiscal variables (tax rates, government spending, and public debt).
 - $GDPGrowth_{it}$ is a control variable for the macroeconomic environment.
 - ϵ_{it} is the error term.
- 3. Econometric Techniques:
 - Data Analysis: If the study involves data from multiple years, panel data analysis (e.g., Fixed Effects or Random Effects models) would be useful to account for both cross-sectional (across sectors or regions) and time-series (across years) variations.
 - Granger Causality Tests: To check whether fiscal policy variables lead to changes in FDI or if the reverse is true.
 - Cointegration Analysis: If you are using time-series data, this technique would help you analyze long-run relationships between fiscal policy and FDI.

Hypothesis:

- Research Question: How does a reduction in corporate tax rates and the introduction of targeted fiscal incentives impact FDI inflows in Albania, particularly in energy and infrastructure sectors where foreign investors are highly sensitive to initial costs?
- H1: A reduction in corporate tax rates and the introduction of targeted fiscal incentives will likely increase FDI inflows into Albania, particularly in sectors such as energy and infrastructure, where foreign investors are particularly sensitive to initial costs.
- Research Question: What is the relationship between increased government spending on infrastructure and public services and FDI inflows in Albania?
- H2: Increased government spending on infrastructure and public services leads to higher FDI.
- Research Question: What is the effect of higher government debt or fiscal deficits on FDI inflows in Albania, considering potential macroeconomic instability?
- H3: Higher government debt or fiscal deficits have a negative effect on FDI due to potential macroeconomic instability.

These research questions and hypotheses will help provide a clearer framework for exploring the relationship between fiscal policy and FDI in Albania, and they align more directly with the methodology that would investigate these dynamics. By exploring relevant fiscal variables and their potential influence on foreign investment inflows, you can assess the extent to which fiscal policies help or hinder Albania's attractiveness as a destination for foreign investment.

4. Legal Framework

Foreign direct investments (FDI) are investments made by foreign individuals, companies or countries to create or acquire assets and to exercise control over a company or project in a particular country. Legislation governing foreign direct investment varies from country to country, but in general, laws governing foreign direct investment include provisions that may include fiscal assistance, ensuring investor rights, procedures for registration and approval of investments, such as and property rights. Albania offers a quite friendly legal framework as far as foreign investments are concerned. The Law "On Foreign Investments" is based on the principles of equality, non-discrimination and protection of investors.

- There is no need for prior authorization for foreigners to open a business in Albania.
- 100% foreign ownership in an enterprise is possible.
- Foreign investors have the right to repatriate all funds and contributions in nature of their investments.
- Investors are treated in conditions no less favorable than those provided for domestic investments in similar circumstances, except for land ownership, which is regulated by a separate law.
- In any case, foreign investments have no less favorable treatment than that provided by the generally accepted norms of international law.
- A company with participation of foreign investments has the right to employ foreign citizens.
- Private property and investments are protected by law from expropriation, or from measures with a similar effect, except for cases when the expropriation is carried out for a public purpose.

- In all cases and at all times, investments have equal and impartial treatment, enjoy full protection and security.

Also, Albania has tried to create a suitable climate for investments by adopting other laws for foreign direct investments, such as the Law on Exports, the Law on Bankruptcy, the Law on Competition, etc. While Albania's legal framework offers strong protections for foreign investors, the practical effectiveness of these protections is sometimes hindered by issues such as corruption and inefficient enforcement of laws. This discrepancy between law and practice may deter potential investors, despite the existence of favorable legal conditions on paper. To encourage FDI, Albania has built institutions such as the Agency for the Promotion of Foreign Investments (APFI), the Agency for the Promotion of Export (AEP), the Agency for SMEs, etc.; and has signed and implemented free trade agreements with other countries in the region.

5. Foreign Direct Investments (FDI) as a Growth Promoter of the Albanian Economy

For the year 2023, the main source of FDI stock inflows was Electricity, gas, and water supply representing 24.3% of the total stock. Other economic sectors with a high contribution to FDI in stock terms are the Extractive Industry sector with 16.5%, Real Estate Activities with 12.5%, Financial and Insurance Activities with 11.7% and Information and Communication with 10% to the total.

Let's look at some of the ways FDI affects the country's economic growth:

1. Foreign Direct Investments (FDI) have an extraordinary role in the economic development of Albania, contributing to the increase of productivity, the creation of jobs, and the improvement of infrastructure. Despite the fact that Albania has gone through various economic periods and deep challenges, foreign investments have been a key factor for the stabilization and modernization of the Albanian economy.
2. One of the main advantages of FDI for the Albanian economy is the creation of employment opportunities. Foreign investors, especially in sectors such as tourism, energy, construction and manufacturing, have brought with them opportunities to open new factories, enterprises and businesses. This has contributed to the reduction of unemployment, a problem that Albania has been struggling with for a long time. Moreover, the training and development of the skills of the Albanian workforce have been a direct consequence of the entry of these investments, helping to improve the quality of work and increase productivity.
3. Foreign investment has also had a positive impact on improving infrastructure, including roads, energy and telecommunications systems. This has enabled the development of other sectors of the economy, creating a favorable environment for business and increasing the attractiveness of Albania as a destination for other investments.
4. Another important aspect is the impact of FDI on the balance of payments and the financial stability of the country. Many of the foreign investments have brought significant capital that has enabled the financing of large infrastructure projects and the development of new industries, contributing to the reduction of dependence on external financing and helping to strengthen the local currency, the lek.

To maximize the benefits from FDI, Albania must create a favorable business environment, improving the investment climate and providing support for investors.

6. Foreign Direct Investments and Tax Burden

Albania has seen a significant increase in foreign direct investment in recent decades, especially after market opening and reforms made to attract foreign investors. The energy, tourism, construction and agriculture sectors are some of the areas that have attracted the most investments. One of the main reasons for this growth is the government's policy to provide tax breaks and a favorable environment for businesses. The Albanian government has offered tax incentives, exemptions and reductions for investors who come to the country and create new jobs. Albania has one of the highest net FDI inflows (8.3% of GDP) even though it has one of the lowest tax burdens (24.4% of GDP). When we analyze the effect of the tax burden according to the statistics of net FDI as a percentage of domestic production, it is observed that the countries with the highest FDI do not have the same performance with the tax burden. The reason for the non-interference of tax burden, tax rate and foreign investment is the best reflection of the role played primarily by the investment climate in a given country. The reason for the non-interference of tax burden, tax rate and foreign investment is the best reflection of the role played primarily by the investment climate in a given country. Fiscal policy has the effect of absorbing investment, but this happens as market conditions and rules are perceived by investors according to investment indices with positive situations and above their average levels. On the other hand, the need for developed systems of the financial market, the capacities of the labor market together with the level of corruption have another impact on the absorption of investments and the development of the internal market.

However, although tax systems have improved, Albania still faces significant challenges in managing the tax burden on foreign investors. One of the main concerns is the high level of fiscal evasion and informality in the economy. This situation makes it difficult for the government to raise the necessary revenue and creates an uncertain environment for investors. When investors feel uncertain about tax obligations, they may be reluctant to invest, reducing the potential for economic growth. Another problem is the complex tax procedures. Many investors report that the registration, tax compliance and reporting processes are complicated and time-consuming. This bureaucracy can deter potential investors who are interested in investing in Albania. The government has made efforts to simplify these processes, but still much remains to be done to create a more favorable environment for business.

One of the benefits of foreign direct investment is increased tax revenue for the government. As investment increases, the government can collect more revenue from corporate taxes, personal income taxes, and consumption taxes. This increase in income is important for financing public services and development projects, thus improving the quality of life for citizens. In order to optimize the relationship between foreign investments and the tax system, Albania can adopt several strategies. The first is the simplification of tax procedures and the digitization of tax registration processes. This will help to cut red tape and make the system more efficient for investors. The second is the creation of a clear and stable tax environment that helps investors understand their commitments and plan their long-term investments. Despite Albania's competitive tax rates, it faces stiff competition from other emerging economies offering similar or even more attractive tax incentives. This international tax competition can make it difficult for Albania to maintain its competitive edge unless it also addresses non-tax barriers such as corruption and inefficiency in government services.

7. Foreign Direct Investments (FDI) 2008-2023

Foreign Direct Investments reached a historical record for 2023. According to the data from the Bank of Albania, they marked the value of 1.49 billion euros, an increase of 8.7% compared to a year ago. However, the growth was significantly slower compared to the level of 33% in 2022. Although FDI inflows have been quite variable according to business cycles, since 2015 the stock of FDI in Albania has maintained a trend increasing until Q-IV 2019 and has started to recover again during Q-II 2020. During 2023, FDI flows reached 1,492 million Euros, 54% of which are reinvested profits that have increased since 2017. Meanwhile, during 2023, the FDI stock increased by 20% compared to the previous year, reaching 13,309 million Euro. While new foreign investments generally come in foreign currencies, the reinvested profits of foreign companies are figures reported in Lek, which are converted to Euro, which is also the currency in which the Balance of Payments is reported for statistical purposes. The significant increase in the weight of reinvested profits in the structure of foreign direct investments can be partially explained by the strengthening of the Lek in the exchange rate. In this way, the strengthening of the Lek seems to have created a vicious circle, statistically affecting the increase in the value of foreign investments.

According to the Bank of Albania, during the fourth quarter of 2023, foreign exchange inflows in the form of foreign direct investments were mainly concentrated in real estate, to the extent of 26%, the financial intermediation sector, to the extent of 17%, in the hydrocarbon sector, in the amount of 16%, in the energy sector, in the amount of 10%, as well as in traffic, in the amount of 4%. These data confirm the high weight that the real estate sector has gained in the structure of foreign investments.

According to estimates by the Albanian Real Estate Association (NAREA), especially in the coastal areas of southern Albania, foreign or non-resident buyers are dominant, with about 70% of purchase transactions. The strong increase in property prices in recent years has made real estate an even more attractive alternative to invest. This has increased the number of buyers who have purchased properties no longer for residential needs or family use, but for investment purposes. An important role is being played by the ongoing investments of existing enterprises, especially in the financial and hydrocarbon sectors. The financial sector and especially the banking sector have increased their contribution in recent years, also due to the gradual increase in regulatory capital requirements for commercial banks.

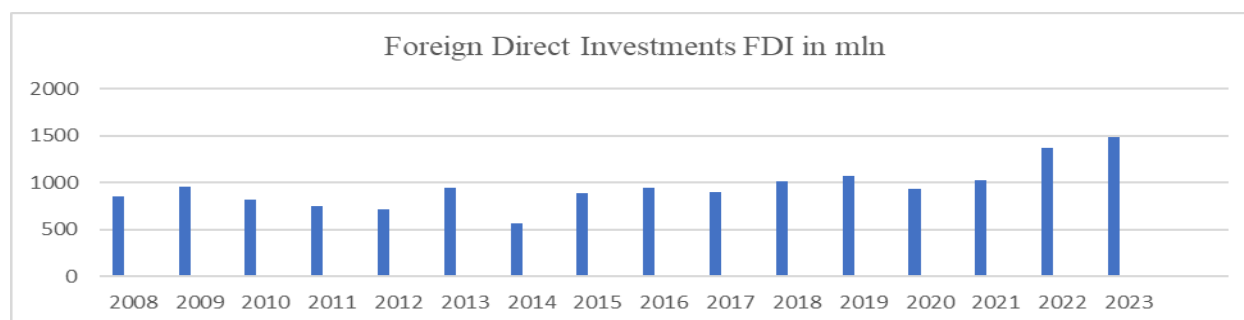


Figure 1. Foreign Direct Investments FDI in mln

Source: Bank of Albania

Foreign Direct Investments in Albania have reached the highest inflow value in 2023, surpassing the record set last year. The flow of FDI for 2023 reached the value of nearly 1.5 billion euros, increasing by 9%, compared to the previous year. This inflow is led by the Netherlands, which accounts for 20% of the total flow, followed by Italy with 14% and

Turkey with 12%. The sectors with the highest contribution are Real Estate Activities with 22%, Extractive Industry with 18% and Financial and Insurance Activities with 16%.

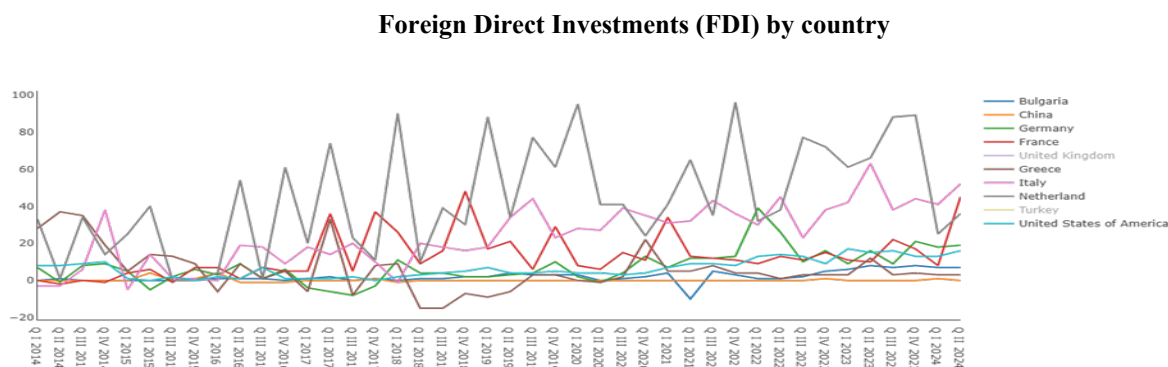


Figure 2. Foreign Direct Investments (FDI) by Country

Source: Bank of Albania

Real estate is leading foreign direct investments even during 2023. According to the data from the Bank of Albania, for the first three months of 2024, foreign investments in real estate in Albania reached the value of 97 million euros, the highest ever recorded for this period of the year.

Compared to the same period last year, foreign investments in property have increased by 24%. Foreign direct investments in real estate reach the value of 181 million euros, an increase of 43% compared to the 6-month 2023. Even the progressive values are the highest historical foreign direct investments in property for the period. Investments in real estate comprised more than 24% of foreign direct investments for the 6 months of 2024.

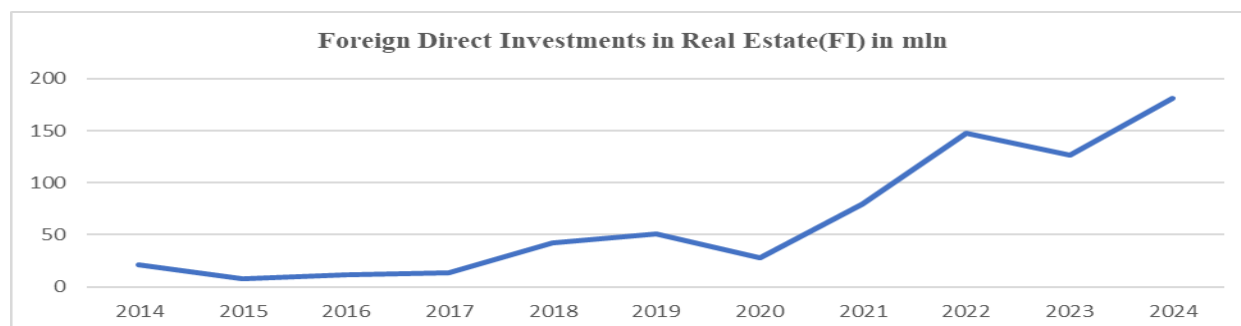


Figure 3. Foreign Direct Investments in Real Estate (FI) in mln

Source: Bank of Albania

Even the progressive values are the highest historical foreign direct investments in property for the period. Investments in real estate comprised more than 24% of foreign direct investments for the 6-month 2024. Purchases by foreign or non-resident citizens have been an important factor in the growing cycle of real estate in recent years. The discovery of Albania as a tourist destination, the lower cost of living and relatively cheaper prices compared to competing markets have pushed many foreign or Albanian citizens living abroad to invest in a property in Albania, especially in the coastal areas. According to the survey of the Bank of Albania for the progress of the real estate market, in the first 6 months of this year, about 27% of the apartments sold were reported to have been bought by non-resident citizens. Of these, about 61% are citizens of European Union countries.

8. Results and Discussions

This study diagnoses the impact of fiscal policies on Albanian economic growth and identifies the challenges that affect one of the government's priority objectives—sustainable economic development. The effects of these policies suggest a direct link to improvements in the quality of governance, which ultimately contributes to enhanced social welfare.

Fiscal policy in Albania has played a key role in attracting foreign direct investments (FDI) by offering tax incentives, reducing corporate tax rates, and improving the overall business climate. These measures have made Albania a more attractive destination for foreign investors. However, while these fiscal reforms have achieved positive results, further advancements are necessary to fully maximize FDI inflows and their potential long-term benefits.

For Albania to optimize the positive effects of FDI on economic growth, policy stability, transparency, and institutional strength must be strengthened. More specifically, improving the consistency and predictability of fiscal policies would reduce investor uncertainty and encourage longer-term commitments from foreign enterprises. Enhanced institutional frameworks that emphasize legal certainty and better governance practices would also foster an environment conducive to sustainable growth. The study suggests that in addition to fiscal incentives, the government could focus on improving regulatory frameworks and fighting corruption, which would further increase investor confidence and, by extension, contribute to social welfare through job creation and skill development.

9. Conclusions

Foreign direct investments (FDI) play an important role in the economic development of a country, bringing many benefits to different sectors of the economy. They provide opportunities for capital growth, technology transfer and infrastructure advancement. One of the main benefits is the creation of new employment opportunities, as foreign investors often open factories, branches and other enterprises, contributing to reducing unemployment and improving the skills of the workforce through training and professional development. Moreover, foreign investment can help stabilize the country's economy by improving the balance of payments and reducing dependence on external sources of financing. They also strengthen the local currency and help improve living conditions for citizens. On the other hand, increasing competition and efficiency is another important advantage, as foreign investors often bring more advanced management practices and new technologies that improve domestic sectors and make them more competitive in the market. Foreign investment can also contribute to the development of new sectors, such as high technology, renewable energy and financial services, diversifying and modernizing the structure of the economy. This increases the possibilities for sustainable and long-term development. In general, foreign direct investments are important for sustainable economic growth, for the improvement of living conditions and for the development of new sectors, providing opportunities for improving the skills of employees and strengthening competition in the market.

In conclusion, while Albania has made significant strides in attracting FDI through favorable tax policies, fiscal incentives, and infrastructure improvements, challenges such as corruption and bureaucratic inefficiencies still hinder the country's full potential. To maximize FDI inflows, Albania must not only refine its fiscal policies but also strengthen governance, enhance transparency, and simplify administrative processes to ensure a stable, investor-friendly environment.

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