Response to Reviewers

Reviewer #1:

The paper deals with the empirical analysis of the impact that FDI inflows may have on poverty reduction with respect to a sample of Western Balkans countries over the years 2002-2018. The paper belongs to the huge literature dealing with the macroeconomic impact of FDI. Most of the literature is concentrated on the study of the linkage between FDI and growth while less empirical evidence has been produced on the linkage between FDI and poverty reduction. The paper adopts a quite standard approach in its theoretical and empirical framework. The main value added lies in the countries considered, that are Western Balkans ones, on which studies mainly analysed FDI determinants but not their impact. Moreover, only recently this geographical area experienced a relevant flow of inward FDI.

I make some suggestions to improve the paper:

1. First, as the originality of the paper is limited to the geographical area analyzed it should be clear from the introduction that this is the main value added of the paper. The authors should highlight more that not many studies exist with specific focus on this area. For example, there are papers that take into consideration the determinants of FDI location choice (e.g. Kurtovic et al. 2020) but not their impact.

   **REPLY:** Thank you for these observations. We agree with both reviewers and we have highlighted the importance of the region, as they have many features in common: similar historical background, similar transition process with high political and economic instability experiences, and an image problem. Also because the Western Balkan countries have received considerable inflows of FDI over the recent years, which makes it interesting and relevant to study their economic effects and with a special focus on poverty, since Western Balkans are still the most vulnerable area towards poverty in all Europe.

   (introduction section, page 3)

2. Connected with this point, as the role of FDI in reducing poverty has received less attention than the impact on growth the authors could discuss about some papers that also with respect to European countries provide some empirical evidence (e.g. Teixeira and Loureiro, 2019, in the case of Portugal), or with respect to other developing countries. One case particularly relevant is the role of FDI in Africa in reducing poverty as analysed in Gohou, G., & Soumaré (2012). In this way the originality of the paper can stand out more clearly. Moreover, as a general comment, the references to the literature are a bit old and some more recent papers could be cited. Such as for example there are some meta-analysis dealing with FDI impact (e.g. Iwasaki and Tokunaga, 2014) that could be taken into consideration.

   **REPLY:** We agree with the reviewer and we have updated the literature review. We also have added a paragraph on the empirical link between FDI and Poverty Reduction where most of the authors (such as Sharma and Gani (2004); Gohou and Soumare (2012); Fowowe and Shuaibu (2014); etc.) confirm the positive effect of FDI on HDI and poverty reduction. (literature review, pages 7-10)

3. Always from a theoretical point of view, the mechanisms linking FDI with poverty need to a bit more explained in detail, in particular the linkage with growth. In the present version there are two subsections dealing with the impact of FDI on growth and the impact of FDI on poverty reduction but it is not clear which is the linkage between the two, even though the authors in the introduction specify that they want to study the impact of FDI on poverty reduction through the indirect channel of growth.

   **REPLY:** We agree with the reviewer and we added another section on FDI economic growth and poverty reduction (literature review, page 11)

4. As poverty is the key impact variable I suggest to build a table, similar to table 1 in which the data by country/year are reported.

   **REPLY:** Done (Table 3, page 16)

5. From an empirical point of view the methodologies are appropriate even though the authors can think to run some robustness checks: for example, consider what is the effect of absorptive capacity, such as % of tertiary education, or other variables that can mediate the impact.

   **REPLY:** Tertiary education or lower level education is not included in the econometric analysis, due to inexistant data on this indicator for Bosnia-Hercegovina and Kosovo. As an alternative to that indicator, we use the Human Development Index that include years of schooling.

6. If possible, it would be interesting to see what are the differences between the impact of greenfield FDI and M&A, as from a theoretical point of view the two impact imply different mechanisms at work. At least the authors can theoretically discuss the point.

   **REPLY:** Done. A paragraph is added on the mode of FDI entrance (literature review, page 8-9).
Reviewer #2:

This paper estimates the impact of foreign direct investment inflows on poverty in six Western Balkan countries, using a GMM model over the period 2002-2018. I found the article interesting and is a clear contribution showing that FDI has significantly contributed to poverty reduction in Western Balkan countries. However, the paper can be improved by clarifying some areas that are listed as follows:

1 - Conceptualization and argument: why the case of the six Western Balkan countries is relevant? What is the pattern of poverty in the Western Balkans? Why are the Balkan countries poor?

REPLY: Thank you for these observations. We agree with both reviewers and we have highlighted the importance of the region, as they have many features in common: similar historical background, similar transition process with high political and economic instability experiences, and an image problem. Also because the Western Balkan countries have received considerable inflows of FDI over the recent years, which makes it interesting and relevant to study their economic effects and with a special focus on poverty, since Western Balkans are still the most vulnerable area towards poverty in all Europe. (introduction section, page 3)

2 - Empirical model: I found the explanation of the empirical model poor. First of all, the choice of control variables is not sufficiently motivated. It is well known that economic growth remains a necessary ingredient for poverty reduction and FDI, as a key vehicle to generate growth, is thus a most important ingredient for poverty reduction (Dollar and Kraay, 2000). To achieve these positive outcomes for poverty reduction, the environment in which foreign investors operate needs to be “right”. The impact can be also accelerated through various channels (see Sumner, A. 2005. Is foreign direct investment good for the poor? A review and stocktake. Dev. Pract. for a detailed discussion).

This part is crucial because it is here where the tools to compare direct and indirect impact of FDI on poverty are defined.

REPLY: Thank you for these observations. We have rewritten the empirical model and this version is enriched a lot, thanks to your suggestions.

The choice of the explanatory variables for the empirical model, where we have added to the existing ones (human development index, corruption, investment freedom, economic freedom, trade openness, and fertility) other variables (remittances, rule of law, labour force participation, private credit, property rights, and corruption is motivated by the existing empirical studies on this topic. We have also utilize as a dependent variable different measures of poverty and income distribution like poverty gap and Gini index. (Page 20-)

3 - Data description and methods:

- Variables: Poverty is a rather complex phenomenon combining several dimensions. A number of variables have been used in the literature to measure poverty. The choice of using the headcount ratio (HCR) is not sufficiently motivated. Furthermore, author(s) should use alternative measure of poverty for a robustness check.

REPLY: Done. In this version of the paper, two alternative indicators are used to measure the poverty level and income distribution, such as the poverty gap and Gini index, in line with what international institutions such as WB, OECD, IDE-JETRO suggest, to provide some robustness checks for the estimated results of the econometric analysis. several measures for poverty are used. (section: variables, page 18)

- Sample and data

The structure of the panel is not clear. Your dependent variable (HCR) is for 6 countries, a period 2002-
2018 (17 years), therefore the total observations are 102, but the number of observations in Table 3 (econometric results) are equal to 174...
Moreover, I understand that the main problem is the availability of data but, in my opinion, the panel dataset is very poor, so author(s) should try to increase the sample (more years, more countries, or more sectors).
REPLY: The total number of observations is 174 in gross terms, since the database and some of the indicators start from the year 1990. But, since there are a lot of missing data in between and data quality is not that good in the first years of transition, we start the estimation sample from 2002 and indeed, the number of observations in this case is 102.
The number of countries included in the empirical analysis cannot be increased since there are only 6 countries included in the Western Balkan region, and only the latter is on the focus of this study. Also, regarding the comment on expanding time span, we have used in the empirical analysis the latest available data and as already explained in the paper, we couldn’t use any data before the year 2002 due to a large portion of missing data and also of a questionable quality for all the considered countries.

4 - Conclusions: I found the conclusions good.
REPLY: Thank you