

Institutions and the geography of foreign investment in European New Member States and Neighbouring Countries.

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Abstract

The paper aims to investigate the location behaviour of European Multinational Enterprises (MNEs) investing in the New Member States (NMS) of the European Union and in its Neighbouring Countries (NCs). The paper is particularly focussed on the role played by the institutional conditions of the host countries in attracting foreign investors. From a theoretical point of view, the paper is underpinned by the well-known OLI eclectic paradigm, which provides a conceptual explanation of why firms become multinationals. In such a framework, the focus of the paper is on the location dimension of this paradigm. In this respect, the work draws on the literature on MNE location decisions, which is fundamentally concerned with the analysis of the relationship between location attributes and MNE behaviour. To complete the theoretical context, the paper also relies on the literature on the role of institutions in economic performance. In particular, the quality of institutions connected to the notion of economic freedom is investigated in this work. These include the size of host countries' government, the enforcement of property rights and the functioning of the legal system, the institutions related to monetary stability, and the regulations of credit, labour and product markets.

From a methodological point of view, MNE location choices are analysed by means of random utility discrete choice models where the expected utility of MNEs is dependent upon the characteristics of the available alternatives. Hence, a Conditional Logit (CL) model is initially performed. In a second step, a Nested Logit (NL) model is implemented in order to relax the Independence of Irrelevant Alternatives (IIA) assumption made in CL and to explore the geographical structure of location behaviour. Thirdly, the paper considers that MNE preferences for economic institutions may vary according to firms' characteristics. This variation in the attractiveness of institutions is thus investigated by

implementing a random coefficient version of a Mixed Logit (MXL) model, which is still rarely employed in this literature. A measure of the heterogeneity of economic institutions as location determinants is estimated suggesting that in some circumstances MNE location behaviour may respond differently to similar location attributes.

As far as data are concerned, a panel of micro-data on individual foreign investment decisions (from the fDiMarkets database) is employed in the analysis. The sample consists of 8687 foreign investment directed to 23 countries from 2003 to 2008. Preliminary results suggest that foreign investors are strongly sensitive to the quality of host countries' economic institutions when selecting a destination site: this outcome appears to hold across specifications and different models, although coefficients on institutional predictors decrease when the IIA is relaxed.

The contribution of this paper to the research on MNE location choices is double: on the one hand, this kind of analysis rarely focuses on countries or locations outside the European Union or the United States. By contrast, this paper encompasses also European NCs, consisting basically of those countries included in the so-called European Neighbouring Policy (ENP), a tool of the European Commission mainly aimed at favouring prosperity and development in Mediterranean and Eastern European countries that are not part of the European Union. Moreover, European MNEs investing in the Russian Federation are also considered in this study, although Russian Federation is not affected by the ENP. Secondly, most studies on MNE location choices focus their attention on more traditional drivers of MNE behaviour, such as market potential, agglomeration effects, European subsidies, taxation differentials, whilst the role of institutions is much less investigated. In particular, the notion of institutions that this paper adopts, that is institutions connected to the concept of economic freedom, is very specific and rarely explored by existing studies.