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Summary of the report

Inward Foreign Direct Investment in the European Union
Regional Distribution and Determinants

José Villaverde and Adolfo Maza

One of the most striking developments of the last few decades has been the tremendous growth of Foreign Direct Investment (FDI) in the global economy. As a result, FDI is now generally considered to be a key factor in fostering economic growth. It has become a vital component of the economic strategies put forward by most developed and developing countries.

This phenomenon has been particularly salient in the European Union (EU), especially since the launching of the single market programme, the introduction of the euro and the last two enlargements. Therefore, the study of FDI is of paramount interest in the EU, especially from a policy-oriented point of view.

There are numerous studies analysing FDI in the EU, most of them performed, mainly for statistical reasons, on a national level. However, there have been few analyses on a regional level, although these can be much more illustrative. For this reason, the present report, *Inward Foreign Direct Investment in the European Union: Regional Distribution and Determinants*, tries to contribute to the literature by filling this gap. More precisely, the aim of the report is to investigate the regional distribution of inward FDI flows in the EU during the period 2000-2006, particularly with regard to its evolution over time and its main determinants. To this end, it makes use of a new FDI database that, unlike others commonly used, offers information about the total amount of inward FDI within the regions of the EU.

The report begins by focusing attention on the definition of FDI and why it matters for the hosting economies. Subsequently, it briefly reviews the theoretical and empirical literature on the main FDI determinants. From a theoretical point of view, the so-called OLI eclectic paradigm developed by Dunning (1977, 1979) is the most generally accepted approach. According to Dunning, FDI can be explained by paying attention to ownership (O), location (L) and internalization (I) advantages. As this report is mainly interested in explaining the geographical distribution of inward FDI in the EU regions, the advantages of location are of paramount importance and key attention is paid to them. These location advantages are usually divided into three types: economic advantages, political advantages and socio-cultural advantages. From an empirical perspective, the results obtained from the scarce number of papers devoted to the analysis of FDI in the EU at regional level are summarised.

The report then outlines the pattern of regional distribution of FDI in the EU, mainly from a regional perspective, although it also offers some insights from a broader (global and countrywide) perspective. In essence, three pieces of FDI information are presented: its total amount and evolution; its geographical concentration; and some rough but useful indicators of its attractiveness. The concentration issue shows that FDI is not evenly distributed across the territory, thus raising the suspicion (confirmed on the basis of a spatial dependence analysis) that regions with higher/

lower FDI flows might be geographically closer to each other than to other regions.

After that, the central part of the report focuses on the factors that affect inward FDI flows in the EU regions. Before starting this analysis, the report makes some comments about data availability and reliability. To be precise, we face two important problems. Firstly, inward FDI flows change significantly from one year to another mainly due to large mergers and acquisitions. Secondly, the data availability of some potential determinants of regional FDI is rather poor (they are incomplete or simply do not exist). For these reasons, in the present report we use average values for FDI flows and for all the variables that theoretically help to explain them. Given these considerations, our dataset initially consists of a total of 21 variables or FDI drivers.

We then proceed in three steps. Firstly, we perform an exploratory factor analysis. This is because working with such a large number of variables can be difficult and may cause problems in the regression analysis, due to the potential presence of collinearity. According to this factor analysis, the best result obtained is one that is made up of six factors, which are *economic potential*, *market size*, *labour situation*, *technological progress*, *labour regulation* and *competitiveness*. Secondly, on the basis of these six factors, the EU regions are grouped into seven clusters to better understand the FDI attractiveness of each region. Thirdly, we estimate an FDI equation, in which the six extracted factors are taken as independent variables. In particular, we find that location patterns of inward FDI in the EU regions are determined by their *economic potential*, their *labour situation*, their *technological progress* and their *competitiveness*. On the contrary,

market size and labour regulation do not seem to exert any significant impact on these location patterns. Although some minor differences arise, these findings are confirmed when a dummy variable representing regions belonging to Cohesion countries, which is positively significant, is included in the regression analysis.

When controlling for the spatial dependence previously detected, the conclusions are roughly the same, which proves their robustness. Additionally, this result conveys the message that the performance of a region is largely linked to that of its neighbours. This finding suggests that a somewhat loose interpretation of agglomeration could also be regarded as an important factor in explaining FDI location.

Finally, some policy remarks are offered. The main one is that regions trying to attract FDI should implement policies to foster what we have identified as their *economic potential*, their *labour situation*, their *technological progress* and their *competitiveness*. Additionally, and considering the large number of regions in our sample and the huge differences among the seven clusters we have identified, we propose that regionally tailored policies should be implemented to increase FDI regional attractiveness. The types of policies suitable for each region could be devised by jointly considering the cluster they belong to and the factors in which this cluster is weak. In particular, regions belonging to clusters 5, 7, and, especially, 6 need to make considerable efforts to improve their *competitiveness*, whereas regions in clusters 2 and 3 need to promote their *economic potential*. Finally, regions in cluster 1 should pay attention to their *labour situation*, and those in cluster 4 need to focus on enhancing their *technological progress*.