EUROPEAN INTERNAL MARKET AND FOREING DIRECT INVESTMENT. THE DETERMINANTS OF FDI

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Abstract

In this paper we intended to analyse the effects that the incorporation of ten candidate states to the EU- in May 2004- will have over their economies. We studied the role that foreign direct investment (FDI) has played in these countries. We also showed how a country attracts FDI, taking into account size and other factors to which foreign investors are sensitive. In this connection, we monitored several indices to consider social, political and institutional factors which can be relevant to foreign investors from a competitive point of view.

Another question to be answered is whether the new regional integration would modify the location of activities in the European countries. We will analyse this question by the role of multinationals companies across Europe.

Key words: Foreign direct investment, European integration, Location of activities.

JEL Codes: O52

1.Introduction

The enlargement of the EU will have important consequences over the economic growth of the national states that will join it. It is generally accepted that due to a better accessibility from these new states to the European core, industrial activities may move towards them. Nonetheless, it is also possible that production may concentrate around the areas closer to the markets, although their costs of production were higher. The consequences of being an EU member state can best be approached with the help of trade theories.

Traditional theories of international trade, based in unrealistic hypothesis (perfect competition, constant return of scale…), can

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incorporate the mobility of the capital, in which case it is not only important the gap in the price of factors but also the differentials in productivity. In general conditions, it will expect positive effects of regional integration on FDI. The integration process will be likely to have a positive effect on intra-EU FDI and an ambivalent effect on extra- EU FDI.

New theories of international trade- Krugman (1979), Brander and Krugman (1983) and Helpman and Krugman (1985), consider the possibility of firms operating in an imperfect competition context with increasing returns and differentiated goods. These theories predict that the effects of integration process depend on the evolution of transport costs:

In the first stage (with also higher transport costs), it will be more important the flow of direct investment among firms located into the more developed markets, to the detriment of firms located into peripheral regions.

In next stage, these theories also explain that whether the target of the direct investment is to exploit intangible assets, the consequences of European integration over capital flows can be difficult to forecast. Firstly, it can be argued that long run strategies of the firms may change as it is not necessary anymore their presence in every country of the Union. Secondly, location advantages may run in very varied directions.

After a general overview of the economic situation of the European countries, we will start by studying the evolution of foreign direct investment (FDI) flows of the candidate countries and the role of multinationals companies across Europe. In second place, we will monitor several indices to consider social, political and institutional factors which can be relevant to foreign investors from a competitive point of view. Finally, we will address summarily the directions of foreign direct investment (FDI) flows.

The great importance of human capital, social capital and physical capital for economic development, as seen in Neira and Guisan(2002), Guisan and Neira(2006), Guisan(2009) and other studies, implies that FDI is a priority for new EU countries with income per capita clearly below than European average.

2. The main characteristics of candidate states.

The EU has undergone several enlargements since 1957, when the six founder states signed the Rome Treaty. In May 2004, the enlargement process that affected to 10 states (Cyprus, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Malta, Poland, Slovak Republic and Slovenia) had special traits: the high number of candidate states, a territorial increase of 23% and a population increment of almost 75 millions people (with a wide range of cultural endowments).

The adhesion of these ten countries increased considerably population (half of which is from Poland), though both, their fertility rate and their expectation of life was under EU standards. However, in spite of the fact that the GDP growth of candidate states was higher since 1996 to the EU average, in 2001 GDP per head was in every single case under the EU mean (23 thousand €), being their average equal to 10,700 €.

The share in the economy of agriculture in these countries was higher than the European average - 4 % in 2001, twice the EU average. The agrarian employment was considerably higher, representing the 13% of total employment in candidate countries, whereas the employment in services was sensibly lower than that of the EU-15.

Candidate states in which agriculture had a bigger share in total employment were Poland (19.2%), Lithuania (16.5%) and Latvia (15.1%). In the EU-15, only Greece with a 16% in 2001, reached this magnitude, though this figure was still worse in 1985 (28.9%). In Hungary and the Slovak Republic the share of agriculture in total employment was only 6%. Only Cyprus had a lower figure (5%) due to the important role of tourism in the island (71% of total employment in services).

The candidate countries presented low salaries, reduced tax and easy access by communitarian funds. This had suspected about changes in the location of production towards these countries.

In 2001, the average wage in these countries (460 €) was lower than the European average (2.191€). These figures were drawn on “World Investment Report: The shift towards services” (UNCTAD, 2004).

In the world ranking for enterprise tax, seven candidates countries (Cyprus, Hungary, Slovakia, Baltic countries and Poland) are positioned between eleven countries with a lower tax level.

In 2004-2006, the amount of communitarian funds toward the new states (21.500 billions €) was driven an economic activities as Transport and Communication, Human Capital and competitiveness between firms.

3. A short perspective of the mobility of factors in Europe.

Regions within a country are usually more specialized than countries, and also have a stronger mobility of factors of production. As a result of the unification of the national markets, the geography of production in the EU may go closer to that of a big national economy.

Mobility of labour, which has not been too important in last decades among developed countries, is typically stronger within a country that among countries. The incorporation of new states to Europe, will make the movements of their nationals around the EU easier. However, in spite of the wage differentials, Europeans have shown a deep attachment to their homelands.

Conversely, there has been a considerable increase in the movements of capital. Eventually, the regions of the EU will have to compete in order to attract and even maintain the mobile factors and, from this competition it may start an accumulative process of unequal growth.

FDI is a way of international loan, by which those countries that have better investments opportunities at the present borrow from those that have capital surplus. For less developed countries, FDI can be an important instrument to fuel their economic growth. In this connection, we should bear in mind that FDI can, on the one hand, encourage technological development and, on the other, support the accumulation of physical capital.

Borensztein et alter (1998), analysing 69 developing countries, concluded that it can be empirically proved that there is a process of

technological transmission associated to FDI in those countries that have reached the threshold needed for technological absorption. In the context of the candidate states, which still have a deep technological and development gap with the EU member states, FDI can play an important role in promoting real and technological convergence.

Multinational enterprises are the main instrument in order to channel FDI. In this connection, we can differentiate two ways of FDI if we combine both location and ownership advantages to the multinational enterprises:

-Horizontal Direct Investment: A firm has several production plants located in different countries but producing identical goods, in order to place its production closer to foreign markets. In this case, it seems reasonable to think of FDI replacing some final goods imports from the country of origin. Acting as a substitute to trade, horizontal FDI gives investors strategic market access and reduces delivery time.

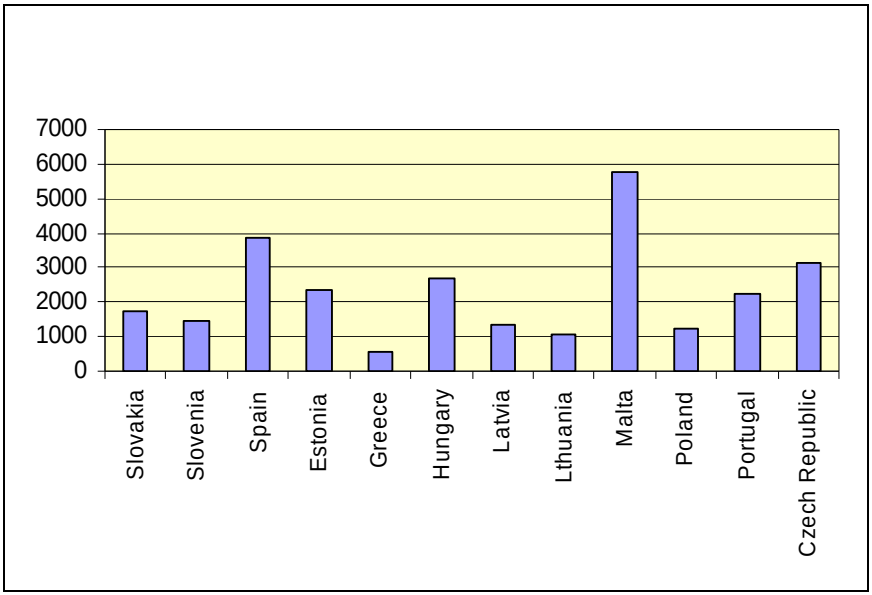
- Vertical Direct Investment: In this case, the different steps of production process have place to those countries in which production cost are lower. It is probably that both FDI and intermediate goods exports of the source country increase simultaneously.

A mixture of both is possible, Conglomerate Mergers and Acquisitions (M&As) which take place between companies in unrelated activities seeking to diversify risk and to deepen economies of scope.

Graph 1 presents annual FDI inflows per head by Spain, Portugal, Greece and acceding countries in million 2000 US$. (In order to asses the effect of FDI over economy, gross capital inflows are usually used. Otherwise, we would be attributing to capital outflows an opposite and symmetrical role over technological development and capital accumulation to the positive effects of capital inflows).

In 1995-2003, Malta received FDI inflow of 5760 2000 US$ per head, which was even higher than those of Spain. Czech Republic and Hungary were the following with nearly 3000 2000 US$ per head. Conversely, Greece has received less FDI lastly. In absolute terms, the main receivers of foreign investments have been Poland, the Czech Republic and Hungary.

Graph 1. Annual FDI inflow per head, 1995–2003. 2000 US$ (2000 Exchange rates).



Own elaboration from IFM and UNCTAD.

In table 1, we may observe that the acceding countries are net receivers of foreign investments. All candidate states- but Latvia, Lithuania and Poland- have received higher FDI inflows between 2000 and 2003. Last years, the net FDI inflows have been increasing in Slovakia, Slovenia, Estonia and Czech Republic. However, the FDI outflows are higher than inflows in Portugal, Spain and Greece despite the fact that its have experience an increase in FDI inflows.

The FDI inflows in Czech Republic and Slovakia are around the 35% of their GDP. These figures are as similar as those of net FDI inflows. In Estonia, these ratios were 32% and 23.5%, respectively. Last years, these states received FDI inflows higher than their gross investment in fixed capital. Germany and Nederland are the most important investors in Slovakia and Czech Republic with the 60% of total FDI stock (See

Frías et al. (2005)). However, the 80% of the total FDI stock in Estonia comes from the Finland and Sweden.

Table 1. Annual FDI per head (2000 US$) (2000 Exchange rates)

	Inflows		Net inflows	
	1996-1999	2000-2003	1996-1999	2000-2003
Slovakia	290.7	1424.9	309.0	1410.7
Slovenia	351.9	1061.0	316.9	798.0
Spain	895.4	2858.4	-863.0	-418.0
Estonia	881.5	1331.2	697.7	976.5
Greece	207.2	286.9	133.1	-20.8
Hungary	1259.4	1001.1	1169.9	788.2
Latvia	715.4	537.5	680.1	512.9
Lithuania	555.7	465.7	544.0	449.9
Malta	3410.6	2044.7	3214.5	1881.3
Poland	558.2	566.7	547.6	554.5
Portugal	723.3	1459.5	-126.0	-296.4
Czech. Rep.	1107.6	1806.7	1073.4	1757.1

Own elaboration from IFM and UNCTAD.

Table 2. Percentage of FDI flows over GDP. (%GDP)

	Inflows		Net inflows	
	1996-1999	2000-2003	1996-1999	2000-2003
Slovakia	8.2	35.9	8.6	35.5
Slovenia	4.2	10.6	3.8	8.0
Spain	6.9	19.9	-6.4	-3.0
Estonia	26.2	32.2	20.6	23.6
Greece	2.2	2.7	1.4	-0.2
Hungary	31.2	20.9	29.0	16.5
Latvia	27.9	16.2	26.5	15.5
Lithuania	18.7	13.3	18.3	12.9
Malta	40.9	23.8	38.5	21.9
Poland	14.3	12.9	14.1	12.6
Portugal	7.5	13.9	-1.2	-2.8
Czech. Rep.	22.9	34.8	22.2	33.8

Own elaboration from IFM and UNCTAD

Table 3. % of FDI flows over Gross Investment in fixed capital (GIFC)

	Inflows		Net inflows	
	1996-1999	2000-2003	1996-1999	2000-2003
Slovakia	24.6	131.9	26.8	130.6
Slovenia	18.3	45.9	16.6	34.7
Spain	30.0	79.1	-27.4	-11.8
Estonia	94.6	116.7	73.8	85.4
Greece	10.9	11.3	7.5	-1.7
Hungary	138.3	89.2	128.8	70.2
Latvia	132.5	60.5	127.3	57.8
Lithuania	79.2	66.1	77.5	64.1
Malta	166.1	81.0	156.5	73.8
Poland	63.9	61.2	62.7	59.7
Portugal	30.4	49.8	-3.7	-9.8
Czech. Rep.	79.3	122.4	76.9	119.0

Own elaboration from IFM and UNCTAD.

Table 4 presents the FDI inflows in eight acceding countries in 2002-2003. We can see that the FDI inflows have been decreasing from 18.988 to 8.426 millions of 2000 US$. These countries did not improve their position in FDI inflows because of direction of FDI inflows did not change into EU.

Table 4. FDI Inflows in acceding countries (but Malta and Cyprus). Millions of 2000 US$. (2000 Exchange rates)

Acceding countries EU 25.	2002	2003
Slovakia	3747.81	402.42
Slovenia	1468.97	135.76
Estonia	254.10	645.20
Hungary	2198.64	1540.56
Latvia	375.20	315.37
Littuania	662.29	136.26
Poland	3685.02	3569.27
Czech. Rep.	6595.99	1681.40
TOTAL	18988.02	8426.25

Own elaboration from IFM and UNCTAD.

In 2003, the decrease in FDI inflow was due to diminishing FDI inflows in Czech Republic and Slovakia. These countries were a main contribution to economic growth by privatisation process in 2002. Moreover, both countries have been chosen as location of new plants by automobile TNCs (PSA and Hyundai in Slovakia and Toyota-PSA in Czech Republic). The implementation of these projects will finish in 2005-2006, when the investment taken place.

4. **Foreign direct investment indices.**

Two simple ways to benchmark FDI are: to compare the absolute values of inflows in the host economies and to calculate the shares of FDI in national investment. However, these comparisons do not take into account the size of host economy as far as it is a reasonable supposition that the larger economy (measured by GDP) will get the more FDI. It is more interesting to assess how successful an economy is in attracting FDI after taking size into account which can implicitly capture the effect of other factors to which foreign investors are sensitive. Following the World Investment Report 2002 *Trans-national Corporations and Export Competitiveness*, we have elaborated two indices of foreign investment: the Performance and the Potential index.

The FDI Performance Index is the ratio of a country's share in the FDI flows of the countries considered to its share in the GDP of these same countries. This index will take the relative economic size into account because countries with an index value greater than one attract more FDI than may be expected on the basis of relative GDP. However, it is not possible to capture the host of factors that can affect FDI by this index. That is why we are going to introduce the following index.

The FDI Potential Index does not explain flows of FDI in a statistical sense. It tries to take into account social, political and institutional factors, which could be relevant at the national level to foreign investors from a competitive point of view. Therefore, this index is built on the basis of these key factors, that are expected to affect FDI, and whose data are available for the analysed country group.

Table 5a. Components of the FDI Potential Index

	GDP growth (av. 2001-2003)		GDP per head (av. 2001-2003)		Exports (av. 2001-2003)		Telephone Lines 2002	
	%	Score (0-1)	$ 2000 PPP	Score (0-1)	% GDP	Score (0-1)	per th people	Score (0-1)
Czech R.	2.67	0.34	14712	0.49	56.94	0.90	362	0.37
Estonia	5.67	0.76	11080	0.19	55.25	0.87	351	0.33
Hungary	3.40	0.44	13409	0.38	54.48	0.85	361	0.36
Latvia	7.00	0.94	8744	0.00	27.97	0.37	301	0.13
Lithuania	7.40	1.00	10004	0.10	39.16	0.57	270	0.01
Poland	1.60	0.19	10295	0.13	22.14	0.26	301	0.13
Slovak R.	4.13	0.54	12643	0.32	62.64	1.00	268	0.00
Slovenia	2.83	0.36	18181	0.77	47.03	0.72	405	0.54
Malta	2.63	0.33	17938	0.75	58.60	0.93	523	1.00
Spain	2.40	0.30	20945	1.00	19.01	0.20	434	0.65
Portugal	0.23	0.00	17151	0.69	21.30	0.25	421	0.60
Greece	4.03	0.53	17150	0.69	7.80	0.00	491	0.87

Table 5b. Components of the FDI Potential Index (continuation)

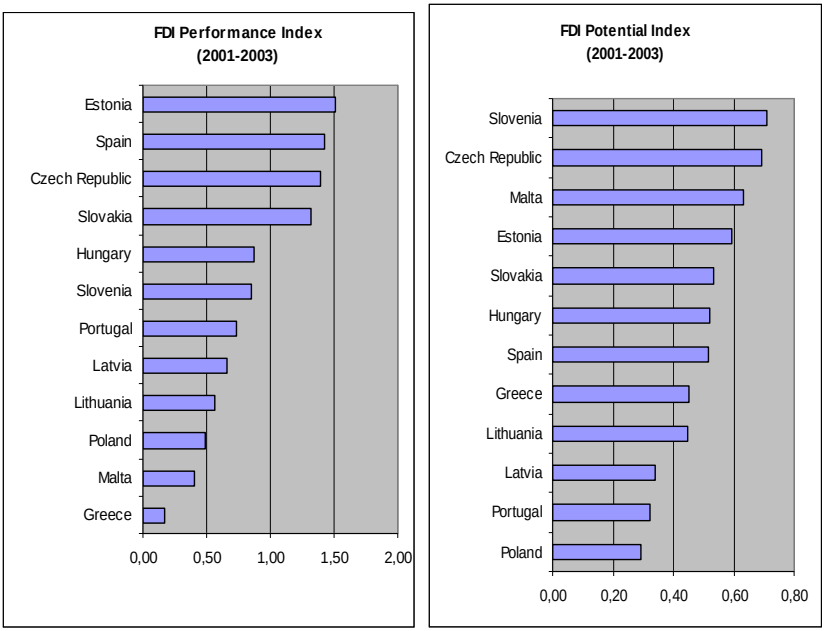
	Commercial energy use (average 2000-2002)		R&D expenditure (average 2001-2003)		Student in secondary education (average 2000-2002)	
	per head	Score(0-1)	% GNI	Score (0-1)	%pop	Score (0-1)
Czech R.	4012	1.00	1.26	0.76	86.73	1.00
Estonia	3383	0.72	0.75	0.30	86.07	0.99
Hungary	2543	0.36	0.98	0.51	70.23	0.75
Latvia	1727	0.00	0.41	0.00	81.60	0.92
Lithuania	2280	0.24	0.68	0.24	84.70	0.97
Poland	2318	0.26	0.61	0.18	80.17	0.90
Slovak R.	3366	0.72	0.60	0.17	84.77	0.97
Slovenia	3399	0.73	1.54	1.00	75.67	0.83
Malta	2064	0.15	-	-	-	-
Spain	3132	0.61	1.03	0.55	39.97	0.30
Portugal	2563	0.37	0.81	0.36	20.03	0.00
Greece	2607	0.38	0.63	0.20	51.83	0.48

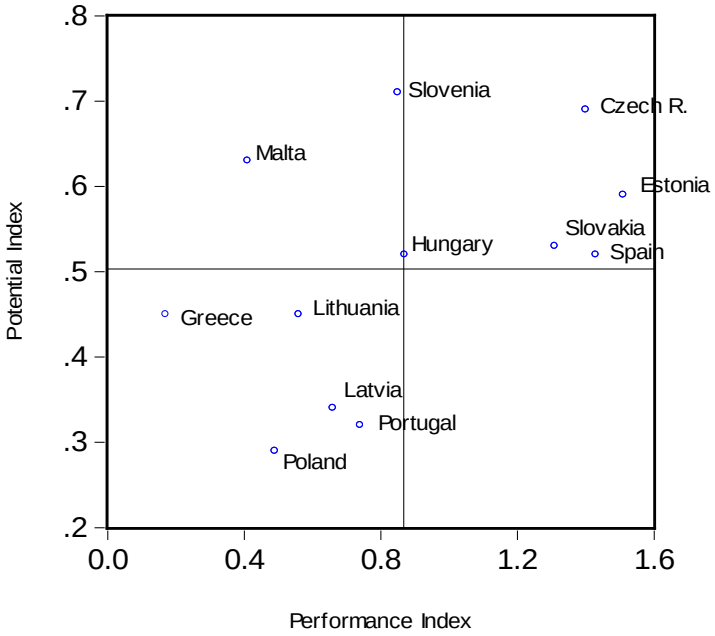
Own elaboration from FMI, UNCTAD and Eurostat. % pop= % schooling age population

The variables which constitute this index are: the rate of growth of real GDP (average 2001 to 2003), GDP per capita (US Dollars at 2000 prices and Purchasing Power Parities, average 2001-2003), share of exports in GDP (average 2001-2003), telephone lines per 1000 inhabitants (per thousand people in year 2002), commercial energy use per capita, share of R&D expenditures in GNI (Gross National Income) and student in Secondary Education as a percentage of population of their age group. The FDI Potential Index is calculated for 2001-2003 as an unweighted average of the normalized values of the aforementioned variables, which are presented in table 5.

The graph 4 shows the rankings in potential and performance indices as well as a scatter diagram in which we can observe the relationship that exists between both of them.

Graph 4 FDI Indexes.





Own elaboration from FMI, UNCTAD and Eurostat.

The country rankings for FDI performance yield interesting results. The countries with an index value greater than one include one Mediterranean country (Spain) and three eastern economies (the Czech Republic, Slovakia and Estonia). The bottom 3 countries are mainly Poland and Greece and a small country (Malta).

Countries with Performance Index values greater than one include economies whose FDI performance reflects the strategic position of some enterprises that seek lower costs and market shares in the emergent states economically and geographically better positioned.

Table 6. Values of FDI Performance Index and Potential Index, and country rankings.

(1999-2001)	Performance		Potential		(2001-2003)	Performance		Potential	
	Value	Rank	Score 0-1	Rank		Value	Rank	Score 0-1	Rank
Czech R.	1.44	2	0.65	3	Czech R.	1.40	3	0.69	2
Estonia	1.18	4	0.58	4	Estonia	1.51	1	0.59	4
Hungary	0.99	6	0.55	5	Hungary	0.87	5	0.52	6
Latvia	0.67	9	0.34	10	Latvia	0.66	8	0.34	10
Lithuania	0.56	10	0.31	12	Lithuania	0.56	9	0.45	9
Poland	0.73	8	0.31	11	Poland	0.49	10	0.29	12
Slovakia	0.80	7	0.47	7	Slovakia	1.31	4	0.53	5
Slovenia	0.23	12	0.74	1	Slovenia	0.85	6	0.71	1
Malta	3.08	1	0.70	2	Malta	0.41	11	0.63	3
Spain	1.26	3	0.52	6	Spain	1.43	2	0.52	7
Portugal	1.04	5	0.37	9	Portugal	0.74	7	0.32	11
Greece	0.23	11	0.45	8	Greece	0.17	12	0.45	8

Own elaboration from FMI, UNCTAD and Eurostat.

Countries with low values of the performance index, which means that the host economy receives less FDI than expected by its size, also vary greatly. Greece is still far from the EU borders and in spite of being members of the EU since 1981, has not improved its investment climate sufficiently to compete effectively for FDI. Others are: a small and tourist country as Malta, and Poland with a transition economy that inspires distrust to foreign investors.

The FDI Potential Index also gives some interesting findings. This index is based largely on structural economic factors and corresponds to the levels of economic development.

The top 3 countries (apart from Malta) include three economies with higher income among the acceding countries (Slovenia, the Czech Republic and Estonia). The 3 countries at the bottom of the ranking are two countries with economies in transition (Poland and Latvia), as well as a developed country (Portugal).

It is useful to compare the rankings based on the two indices as a rough guide to know whether countries are performing adequately, given their structural indicators. Comparing the two indices we can draw up a four-fold matrix of inward performance and potential indices, as follows:

- "Front-runners." Countries with high performance (i.e. above the mid-point of the ranking by performance) and high potential (i.e. above the mid-point of the ranking by the potentiality).
- "Above-potential." Countries with high performance (i.e. above the mid-point of the ranking by performance) and low potential (i.e. below the mid-point of the ranking by the potentiality).
- "Below-potential." Countries with low performance (i.e. below the mid-point of the ranking by performance) and high potential (i.e. above the mid-point of the ranking by the potentiality).
- "Under-performers." Countries with low performance (i.e. below the mid-point of the ranking by performance) and low potential (i.e. below the mid-point of the ranking by the potentiality).

Table 7. Country classification by FDI performance and potential indices (2001-2003).

	High Performance	Low Performance
High Potential	**Front-runners** Czech Republic, Estonia, Hungary, Slovenia, Slovakia	**Below potential** Malta
Low Potential	**Above potential** Spain	**Under-performers** Latvia, Lithuania, Poland, Portugal ,Greece

Own elaboration from FMI, UNCTAD and Eurostat.

In 2001-2003, there were 4 *front-runners*, countries that combine strong potential and performance indices. This group includes countries are located next to large developed economies as Estonia (Scandinavian

states), the Czech Republic (Germany and the Netherlands), Slovenia (Austria and Italy), and Slovakia and Hungary (Germany and Austria).

There were 5 *under-performers* -Latvia, Lithuania, Poland, Portugal and Greece- whose economies are not advantaged enough and competitive to capture foreign capitals and are receiving foreign capital according to this.

The group of *above-potential* economies comprises mainly countries without strong structural capabilities that have done well in attracting FDI. It is the case of Spain with weak structural indicators.

The group of *below-potential* economies includes a small and tourist country as Malta.

The evolution of both indices from 1999-2001 to 2001-2003 shows:

-The situation of Slovenia has changed. In 1999-2001, the FDI inflows in this country were poorer in spite of having a high potential but a high performance during the last period transformed these country in a front-runner.

-Slovakia has changed the role of under-performer to front-runner.

-The position of Portugal has dropped in 2001-2003 with a decrease of FDI inflows and worse structural indicators.

6. Main conclusions.

These are the main conclusions drawn from the present paper:

- The acceding countries are very attractive to foreign investors. This was revealing about what lower salaries, tax level and easier access by communitarian funds were in these countries.
- The candidate countries are net receivers of FDI. Malta, the Czech Republic and Hungary are the main receivers of FDI inflows per head in 1995-2003. However, the evolution in this period shows a decrease of inflows during last 3 years in Malta, an important increase in Slovakia and the Czech Republic.

- Countries with Performance Index greater than one- the Czech Republic, Spain, Estonia, and Slovakia – are those whose FDI performance reflect the strategic position of some enterprises that seek lower cost and market shares in the emergent states economically and geographically better positioned. In the FDI Potential Index, which is based largely on structural economic and social factors, the countries better positioned are: Slovenia, the Czech Republic and Estonia.
- The evolution of both indices from 1999-2001 to 2001-2003 shows good perspectives in Slovenia and a change of role in Slovakia.

As a single conclusion it can be stated that the incorporation of new countries into the EU did not suppose a transpose of FDI inflows in Southern European countries to acceding countries. Spain was kept an advantage position in spite of lower potential. Nonetheless, the investment of TNCs in acceding countries will have an effect on the relative position of the ranking in FDI. Therefore, Spain has to improve the indicators that constitute the FDI Potential Index.

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