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MNEs location decisions in EU neighbouring countries and economic institutions.

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OBJECTIVE

The aim of this paper is to analyse the location strategies of Multinational Enterprises (MNEs) from EU-15 countries in a wide set of destination countries, including EU new member states, accession and candidate countries, European Neighbouring Policy (ENP) countries and the Russian Federation. In this respect, particular attention is devoted to study the role of the quality of recipient countries' economic institutions in driving MNEs location behavior, while most past contributions on this topic has focused on agglomeration mechanisms and differentials in factor endowments.

In this work we look at nearly 7,000 individual investment projects undertaken in 23 host countries from 2003 to 2008. Furthermore, we expand the study of location decisions by employing a random-coefficient Mixed Logit (MXL) model that permits investigating heterogeneous preferences of MNEs over economic institutions.

SCIENTIFIC/RESEARCH METHODS

We employ information on individual investment projects undertaken by multinational firms over the period 2003-2008. Data come from *FDi Markets-Financial Times Business* database, which includes all

cross-border greenfield and expansion investment. Joint ventures are tracked in this database only when they lead to new physical operation, whereas Mergers & Acquisitions as well as other equity investment are not included. Specifically, this paper makes use of investment projects originated in EU countries and directed towards EU New Member States (NMS) and European Neighbouring Countries (NCs), the latter being Accession Countries (ACC), European Neighbourhood Policy (ENP) countries and the Russian Federation. Investment from the entire world towards the same destination countries are also employed to test the attractiveness of the countries of interest towards global capital. From a methodological point of view, this work studies MNEs location behaviour by means of a random-coefficient Mixed Logit model, which is rarely employed in previous research despite its clear advantages over more commonly used methods. In fact, the great majority of studies tend to model MNEs location decisions through Conditional Logit or Nested Logit. The present analysis will implement both these latter models and will compare results with the Mixed Logit.

POLICY VALUE ADDED

Very few studies have empirically investigated the relationship between the quality of economic institutions in recipient countries and the location behaviour of MNEs. Therefore, this paper provides novel evidence on this relationship. Moreover, the set of countries that we include in our sample are strongly under-explored in the literature, mainly due to the difficulty to recover reliable data. For these reason, this paper offers a relevant analysis of location choices of MNEs and it also provides original policy options.

Overall, economic institutions prove to be relevant drivers of MNEs location choices. However, our results highlight that not all aspects of host countries' economic institutional environments matter the same degree. We distinguish between economic institutions related to government expenditure, property rights and the legal system, monetary aspects and regulations in markets. While the first three dimension positively affects the decisions of foreign investors to undertake operations in the group of countries that we analyse, the latter does not seem to be a relevant driver. We also control for a fair number of other standard elements that influence the location behavior of MNEs, such as the size of host markets, market potential, agglomeration forces, trade costs and geography, wages, education levels and so on. These elements also contribute to shape MNEs strategies.

A further interesting finding emerges from the implementation of MXL. The key idea behind the MXL analysis is that MNEs do not attach the same relevance to different economic institutions. Thus, we explore whether heterogeneity in MNEs preferences over economic institutions occurs in location strategies. It turns out that our indicators for property rights/legal system and monetary institutions are subject to a certain degree of taste variation in MNEs preferences. In particular, about one-third of MNEs from EU-15 investing in the area of interest regularly prefer destinations where these

dimensions of economic institutions are less good, while two-thirds of investment goes where these aspects are higher quality. As far as heterogeneity in monetary aspects of economic institutions are concerned, it might be that there are underlying differences at the MNE individual level with respect to the modes of financing subsidiaries' activities. Therefore, MNEs that undertake operations in locations with higher rates of inflation may set up affiliates that borrow money externally from local financial markets rather than internally from the parent company. Since external debt is more plausibly expressed in local currency than internal, higher inflation can erode foreign affiliates' debt. In the case of economic institutions associated with property rights protection and the rule of law, MNEs taste variation appears rather counterintuitive. Nonetheless, there could be situations in which some actors prefer poor economic institutions if they can capture advantages from these weaknesses. Such an institutional subversion phenomenon is particularly documented in the case of transition economies, where political and economic elites basically replicate a system of flawed economic institutions that give them advantage over the rest of the population (Helmann, 1998; Helmann et al., 2000). This subversion of economic institutions is intimately associated with inequality and that less secure property rights as well as weaker legal systems eventually favour a country's establishment, which aims at perpetuating the mechanisms that allow it accumulating power. In this picture, it is possible that some MNEs are oriented towards locations where they can establish influential connections with political and economic elites, which in turn allow them taking advantage of institutional poorness by obtaining rents or circumventing market rules.

Importantly, it must be born in mind that, according to our results, most MNEs prefer locations where economic institutions are better enforced. Therefore, in terms of policy implications, a strong effort should be made to reinforce the institutional setting of European neighbouring countries. This is not only relevant to attract global capital but it is also fundamental to stimulate domestic economies. Indeed, improving economic institutions is very likely to be evaluated as a positive signal by foreign investors overall. This is even more relevant in the case of developing and transition economies, where economic institutions are frequently poor whilst MNEs are increasingly interested in expanding into the new markets that they represent. Although some MNEs appear to be attracted by less good economic institutions, we do not suggest that replicating flawed institutional environment is an adequate policy option. In fact, weak institutions implies distortions in the system of incentives within an economy that are not counterbalanced by more foreign investment. Furthermore, foreign investment attracted by institutional weakness is more likely to benefit local elites than the aggregate recipient economy.