

## D2.4 SEARCH DERIVERABLE

A report including empirical studies on the development of the relations among EU and neighbouring countries based on trade and capital flows which will be edited in a volume or book

November 2013



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## DELIVERABLE 2.4

**A report including empirical studies on the development of the relations among EU and neighbouring countries based on trade and capital flows which will be edited in a volume or book**

**November 2013**

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## 1. INTRODUCTION

The deliverable contains the proposal submitted to “Environment and Planning C: Government and Policy” (EPC) for the publication of a Special Issue under the general title: “The Economic Geography of EU Integration with its Neighbors: Trade, FDI Location and Development”. The research proposal has been accepted from the editors of the journal and the Special Issue is expected to be published by July 2014. The editors of the Special Issue are Dr. Riccardo Crescenzi (LSE) and Professor George Petrakos (UTH). The papers that are going to be included in the Special Issue deal with the issue of “Trade Flows and Localization Choices” (i.e. the WP2 of SEARCH Project).

As far as it concerns the deliverable, the papers are going to be included later on, upon their submission to EPC. For the time being, only the abstracts are available. However, the deliverable contains a paper which will not be included in EPC. The title of the paper is: “Trade activity between the EU and its neighboring countries: Trends and potential” and the authors are: Dr. Dimitris Kallioras (UTH) and Dr. Anna Maria Pinna (CRENOS). The paper has been submitted for publication to “Tijdschrift voor Economische en Sociale Geografie”, in a special issue edited by Professor Ron Boschma (URU), Professor Simona Iammarino (LSE) and Professor Raffaele Paci (CRENOS). Later on, more papers are going to be included in the deliverable.

## 2. THE ECONOMIC GEOGRAPHY OF EU INTEGRATION WITH ITS NEIGHBORS: TRADE, FDI LOCATION AND DEVELOPMENT – PROPOSAL FOR SPECIAL ISSUE SUBMITTED TO EPC

### 2.1. BACKGROUND, EXISTING LITERATURE AND RELEVANT GAPS

The European Neighborhood Policy (ENP), launched in 2004, is a unified European Union (EU) policy framework towards the EU neighboring countries (see Wesselink and Boschma, 2012 for an overview). The objective of the ENP is to strengthen the prosperity, stability and security of the EU, creating a “ring of friends” around the EU political borders. As the Commissioner for Enlargement and ENP, Štefan Füle, stated, “our Neighborhood Policy provides us with a coherent approach that ensures that the whole of the EU is committed to deeper relations with all our neighbors [...]” (Füle, 2013).

The ENP framework applies to the following countries ('ENP countries'): Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine ('ENP East') and Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestine, Syria and Tunisia ('ENP South'). The ENP is synergic to other EU initiatives in this area such as the Eastern Partnership (launched in Prague, in 2009), the Euro-Mediterranean Partnership or Union for the Mediterranean<sup>1</sup> (re-launched in Paris, in 2008), and the Black Sea Synergy (launched in Kiev, in 2008). Even though the ENP is a distinct and separate process from the EU enlargement, ENP countries operate under conditions of 'neighborhood Europeanization'<sup>2</sup> with an apparent mismatch (i.e. the so-called “capabilities-expectations” gap;<sup>3</sup>) between ENP requirements\demands for participating countries (i.e. demands that do not differ much from those of “accession Europeanization”<sup>4</sup>), on the one hand, and potential ENP gains\rewards (i.e. the possibility of EU membership has been ruled out for the majority of ENP countries) on the other (Lavenex, 2004; Lang, 2007; Mahncke and Gstöhl, 2008). As stated by Romano Prodi, former EU Commission President, “we have to be prepared to offer [to the ENP countries] more than partnership and less than membership, without precluding the latter” (Prodi, 2002). Given this fundamental political mismatch – and the generalised skepticism about the possibility to transfer EU values and rules to the neighboring countries – deep(er) economic integration between the EU and the ENP countries is considered as a crucial condition for the success of the entire ENP process (see Dreyer, 2012). As a consequence, the analysis of the process of economic integration between ENP countries and the European Union is

<sup>1</sup> Formerly known as the Barcelona Process (launched in Barcelona, in 1995).

<sup>2</sup> See Axt et al., 2007 and Schimmelfennig, 2012 for a discussion of the “Europeanization” debate.

<sup>3</sup> See Monastiriotis and Borrell, 2012.

<sup>4</sup> See Hughes et al., 2004 and Schimmelfennig and Sedelmeier, 2005 for a discussion about the “Europeanization” of the new EU member-states.

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highly relevant not only to the understanding of the economic linkages and development prospects of both areas but also to the evolution of their political relations.

Even if the proper “membership anchor” is missing (Havlik et al., 2012a and 2012b), the progressive compliance with the *acquis communautaire* is a necessary condition for the ENP countries to increase their weight on the EU market.

In this sense the ENP is simultaneously stimulating economic, political and institutional development (by providing not only incentives but also financial resources). Deeper association with the EU brings a number of political and economic benefits at the domestic national level, strengthening domestic policies and, thus, facilitating political reforms that consolidate the process of political transition, democratization and, in some cases, conflict resolution and normalization of external relations (Monastiriotis et al., 2010). However, together with the aforementioned benefits, the process of European (economic) integration is giving rise to additional processes whose nature and overall impacts remain more ambiguous (Kallioras and Petrakos, 2010). Economic integration reduces the role of national borders as barriers to factor mobility which is further reinforced by the reduction of trade costs. ‘Closed’ borders distort market size effects (Niebuhr and Stiller, 2002), whereas the removal of economic barriers generates (releases) a number of spatial dynamics linked to better access to foreign markets and import competition (Brühlhart et al., 2004). Therefore, even if there is almost unanimous consensus in the economic literature that (market-based) economic integration is a positive-sum game, an on-going debate is currently taking place concerning the distribution of its overall welfare gains (Petrakos et al., 2011). Such a debate finds fertile ground since the size, the composition and the direction of trade and capital flows determine, to a large extent, the prospects (and the limitations) for economic development. In other words, in the economic space emerging in the EU and its neighborhood, the space of flows (i.e. integration) affects, to a great extent, the space of places (i.e. development) (Petrakos, 2012).

## 2.2. RATIONALE FOR THE SPECIAL ISSUE, ORIGINAL CONTRIBUTION TO KNOWLEDGE AND RELEVANCE TO EPC

The general objective of this proposed Special Issue is to advance and consolidate theoretical and empirical scientific knowledge on the patterns of economic interaction between the EU and its neighboring countries, to project future trends and identify the effects of deeper economic integration to the growth, competitiveness and cohesion prospects of the two areas.

The specific objectives of the proposed Special Issue are:

- (a) the analysis of the trade patterns between the EU and its neighboring countries and their possible effects on growth, structural change and cohesion in both areas;
- (b) the analysis of the locational choices of EU mobile investment, the direction and drivers of capital mobility and its effects on the EU neighboring countries;
- (c) the assessment of the efforts made by domestic and foreign firms to invest in technological and organizational capacities with a special focus on the impact of localized institutional environments;
- (d) the analysis of the spatial intra-country effects of stronger trade and investment flows in both the EU and its neighboring countries;
- (e) the discussion of the policy options at the EU level that take into consideration the effects of integration and attempt to increase and spread its benefits on both sides of the external EU borders.

The proposed Special Issue provides innovative empirical evidence in response to the following research questions: (a) how are trade patterns and capital mobility between EU and ENP countries evolving in response to ENP Policy? (b) what is the impact of trade flows and capital mobility between EU and ENP countries on growth, structural change and cohesion? (c) what are the policy implications of the evolution of trade flows and capital mobility between EU and ENP countries?

The papers included in the proposed Special Issue deal with a number of (interrelated) research tasks:

- **Trade patterns in the EU and the ENP countries**

The papers dealing with the analysis of trade patterns in the EU and the ENP countries provide a theoretical discussion and detailed empirical findings on trade patterns and their evolution over time, by sector, origin and destination. The analysis includes intra-industry and inter-industry patterns of trade, patterns of specialization and change as well as export portfolios performance

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and structure, and assesses their effect to competitiveness and growth performance in both economic areas. A number of research methodologies are employed for the analysis of trade patterns. Following basic statistical analysis of the evolution and the patterns of trade, a number of more analytical contributions examine: (a) the degree of relatedness between export products based either on the hierarchical structure of the standard industrial classification (SIC) system, and on co-occurrence analysis (see Hidalgo et al., 2007); (b) the evolution of the export mix of EU and ENP countries over time, and the extent to which new export products are related to existing export products at the national level (see Hausmann and Klinger, 2007); (c) the degree of relatedness between imports and exports at the national level and the possible benefits that national export sectors can derive from learning opportunities in related import sectors (see Hidalgo and Hausmann, 2009); (d) how both integration and the role of trade in the local economies are linked to the types of products that are traded (see Boschma and Iammarino, 2009); (e) the relation between the patterns of integration and the patterns of production in order to evaluate the impact of integration on specialization and growth performance (see Petrakos et al., 2012); and (f) EU trade policies towards neighboring countries, including restrictions arising from sectoral policies like CAP and environmental or quality requirements and standards (see Liargovas, 2011).

- **Capital mobility among the EU and the ENP countries**

The papers dealing with the analysis of capital mobility among the EU and the ENP countries undertake a theoretical discussion and provide empirical findings on the locational choices of EU FDI in the ENP countries. A number of research methodologies are employed for the analysis of FDI patterns. In particular, in addition to the detailed analysis of the evolution of FDI patterns and their geography, the papers included in this section examine: (a) the role of offshoring (or firms' localization in general) in the dynamic evolution of prosperity gaps between more and less industrialized countries in order to assess the risk of the emergence of new economic 'divides' between the EU and its neighbors (see Grossman and Helpman, 2005); (b) how offshoring can impact upon between-countries inequalities and relative dynamic gains and losses (see Naghavi and Ottaviano, 2008); (c) the regional level location determinants of MNCs' investments in the EU neighboring countries (see Bevan et al., 2004); (d) the propensity of MNCs' to invest in technological innovation and organizational upgrading (see Kostova and Zaheer, 1999).

- **Spatial implications of integration and expansion of capital flows in and out of the EU borders**

The final section of the special issue will include papers dealing with the analysis of the spatial implications of integration and expansion of capital flows in and out of the EU borders. The papers will theoretically discuss and empirically investigate the spatial implications of the new wave of integration and expansion of trade and capital flows on both sides of the external EU borders. In particular, the paper will examine: (a) the regional structure of EU neighboring countries and the evolution and typologies of inequalities, as well as of the major drivers of regional performance (see Petrakos et al., 2011); and (b) the spatial impact of trade expansion and factor flows expansion on the performance of economies on both sides of the external EU borders (see Kallioras and Petrakos, 2010).

Overall, the papers included in the proposed Special Issue will provide EPC readership with valuable insights into conceptual and empirical issues of high relevance to the current debate on the process of EU integration (and its future). The empirical analyses included in the special issue will provide the readers with highly innovative evidence on this under-explored set of countries. It is important to highlight that the papers included in the special issue are the key output of a major EU-funded research project. As a consequence, all papers have been designed as a part of coherent line of investigation, share a similar analytical perspective and show a significance degree of internal coherence. The cross-cutting nature of its topic and methodological approach, the relevance to a variety of disciplines (geography, economics, public policy and political science) and its innovative contribution to an emerging literature make this Special Issue an ideal candidate for publication on EPC.

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### 2.3. PAPERS PROPOSED AND POSSIBLE ORDER OF APPEARANCE<sup>5</sup>

1. Riccardo Crescenzi and George Petrakos: Editorial: "The economic geography of EU integration with its neighbors: Trade, FDI location and development"

#### Trade patterns in the EU and the ENP countries

2. George Petrakos, Dimitris Kallioras and Panagiotis Artelaris: "The geography of trade relations between the EU and the ENP countries: Emerging patterns and policy recommendations"

3. Anna Maria Pinna: "Is International Trade changing the Neighborhood of Europe?"

4. Ron Boschma and Gianluca Capone: "Relatedness and diversification in EU and ENP countries"

#### Capital mobility among the EU and the ENP countries

5. Vassilis Monastiriotis and Mireia Borrell: "Origin of FDI and domestic productivity spillovers: Does European FDI have a 'productivity advantage' in the ENP countries?"

6. Andrea Ascani, Riccardo Crescenzi and Simona Iammarino: "What drives European multinational firms to ENPs? A case-study analysis of two large multinationals"

7. Daria Zvirgzde, Daniel Schiller, and Javier Revilla Diez: "Location choices of multinational companies in Ukraine"

#### Spatial implications of integration and expansion of capital flows in and out of the EU borders

8. Ageliki Anagnostou, George Petrakos and Maria Tsiapa: "Integration with the EU and regional inequalities in the ENP countries"

9. Michael Beenstock, Daniel Felsenstein and Ziv Rubin: "The effect of EU foreign direct investment on regional equality in the European Neighborhood: Evidence from Israel"

### 2.4. PROPOSED TIME TABLE FOR INITIAL SUBMISSION OF PAPERS

Articles (length 7,500 words) to be submitted to EPC by early October 2013

Peer review process completed by early December 2013

Revised articles to be submitted to EPC by early February 2014

Special issue to be completed by early March 2014

Publication in 2014-15

### 2.5. GUIDELINES PROVIDED TO THE AUTHORS AFTER THE APPROVAL OF THE PROPOSAL

Dear Colleagues,

We are glad to inform you that our proposal for a special issue of *Environment and Planning C* on 'The European Union and its Neighbouring Countries: The economic geography of Trade, FDI and Development' has been accepted by the Editors. We feel that this is an excellent opportunity given the international standing of this journal and its (increasing) impact factor.

For the preparation of this Special Issue in line with the publication schedule agreed with EPC we propose to proceed as follows:

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<sup>5</sup> The titles and the team of authors of the papers are subject to small changes.

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A) *Special Issue papers in their final versions should be submitted to both Ricardo Crescenzi and George Petrakos by December 22nd 2013 at the very latest;*

B) *We will quickly review the papers to make sure submissions are homogenous enough and that links between papers are sufficiently explicit (this is a major assessment point for the entire Special Issue). After reading all the papers we will also be able to prepare our Editorial introduction paper;*

C) *Where necessary, authors will be asked to amend their papers by January 22nd 2013 before submitting their papers on line directly to EPC. Each paper of the Special Issue (including its editorial) should be submitted on line by the authors by the January 31st 2014.*

D) *Following the submission of the papers the overseeing EPC editor will choose the referees among those specified in our list and consult with George and Riccardo in case of problematic papers/difficult decisions.*

E) *By mid-March 2014 we should receive the first round of referee reports and each author will be responsible for the timely submission of a revised version of their paper so as to satisfy the referees and the EPC Editor.*

F) *The special issue should be accepted for publication by June 2014 in line with the end of the SEARCH project. Please confirm that you are happy with these arrangements and do not hesitate to let us know if you need any further clarification. All the best,*

*Riccardo Crescenzi & George Petrakos*

## 2.6. PAPERS' ABSTRACTS

### **Editorial: The economic geography of EU integration with its neighbors: Trade, FDI location and development**

**Riccardo Crescenzi and George Petrakos**

This Editorial will start with a critical review of the existing literature on the process of political and economic integration between the European Union and the ENP countries with a special focus on the processes linked to trade flows, FDIs and their spatial impacts. The Editorial will single out the key 'unanswered' questions in the existing literature and explore outstanding conceptual and empirical challenges, discussing how the various papers included in the Special Issue can provide systematic coherent answers to a number of these research questions. The Editorial will include a synopsis of the key findings of the papers and will highlight their connections and linkages. Special attention will be devoted to the discussion of policy implications that can be drawn from the systematic analysis of the various papers. The paper will conclude with open questions for further research in order to outline a potential agenda for future conceptual and empirical analyses in this area.

### **The geography of trade relations between the EU and the ENP countries: Emerging patterns and policy recommendations**

**George Petrakos, Dimitris Kallioras and Panagiotis Artelaris**

The European Neighborhood Policy (ENP), launched in 2004, is a unified European Union (EU) policy framework towards the EU neighboring (ENP) countries. The objective of the ENP is to strengthen the prosperity, stability and security of the EU and the ENP countries. Even though the ENP is distinct from the process of EU enlargement, the ENP countries operate under conditions of "neighborhood Europeanization". The objective of the paper is to evaluate the strengths and the weaknesses of the ENP against the backdrop of its trade component. It does so by providing a deep and comprehensive empirical analysis of the geography of trade relations (i.e. the size, the composition and the direction of exports and imports flows) between the EU and the ENP countries.

In particular, the paper addresses a series of empirical questions related to: (a) the impact of the gradual dismantling of economic borders between the EU and the ENP countries on the level of EU-ENP trade activity, (b) the relative importance of the EU-ENP trade for the EU and the ENP countries, (c) the spatial allocation of the EU-ENP trade flows, (d) the sectoral allocation of the EU-ENP trade flows, (e) the pattern of economic integration between the EU and the ENP countries and whether it is balanced or unbalanced, symmetric or asymmetric. The present paper is the first comprehensive paper evaluating (the trade component of) the ENP on the basis of the geography of EU-ENP trade relations. The analysis utilizes trade data derived from the United Nations

(UN) COMTRADE database and refer to the national-sectoral (2-digit SITC classification) level. The analysis covers the period 2000-2010 so as to gauge the latest developments in trade structures as a result of deeper interaction.

The findings of the paper illustrate the emerging patterns of trade relations among the EU and the ENP countries, allowing for the provision of specific policy recommendations regarding the ENP and, in particular, its trade policy component.

### **Firm exporting activity from the EU to the ENCs**

**Anna Maria Pinna**

The goal of this paper is to study empirically the characteristics of European firms which have one of the European Neighbouring Countries (ENCs) as main export destination. Recent evidence on what drives international performance at the country level shows that it is firms that are at the heart of competitiveness. Firms carry out global operations, exporting to, importing from and producing in foreign countries. A crucial issue for policymakers is thus to understand which firm level characteristics explain the global reach and the international performance of European economies more than other features of national economies.

The most complete database which has been produced with this aim is based on the recently collected EU-EFIGE/Bruegel-UniCredit survey of 15,000 manufacturing companies in seven EU countries (Austria, France, Germany, Hungary, Italy, Spain and the UK). Moreover, the EFIGE dataset can be matched with balance-sheet information available from the Amadeus dataset of Bureau van Dijk, thus allowing for the calculation of a number of productivity measures over time. In this paper we use EFIGE data in order to infer on the characteristics of the firms which export to the ENP countries. Out of 15000 thousand firms we isolate 554 firms which have one or more ENP country as their main (1st, 2nd or 3rd) export destination and we are able to infer on their characteristics. Firm characteristics – size, productivity, innovative activity, skill content of the workforce – are the primary determinants of export performance and outweigh country effects. Moreover, firm characteristics affect the probability of engaging in exporting and the share of turnover exported in the same direction: larger, more productive, more innovative firms are both more likely to export and tend to export a larger share of their production (Efige Report, 2011). In this paper we find that, for all EU origin countries, firms which choose to export to the EN area are not significantly different from firms which export to areas which are further apart from Europe. But we find that geography matters: distinguishing across sub-areas within the ENP region is an important determinant in the decision to export or not in the neighboring region. Such pattern is different for the 6 origin countries in our sample. Furthermore we isolate which characteristics, in several firms' dimensions, are important when concentrating on firms which export mainly in the ENCs. Firms' dimensions which we study are related to those characteristics which have been found at the heart of the process of growing and become successful internationally (Bernard, et al. (2011); Behrens, and Ottaviano (2011)). From a policy perspective, the paper makes it possible to understand what types of firms concentrate their export activity on the ENCs area, whether there are differences across six heterogeneous EU countries and how such differences are reflected across 14 destinations in the neighboring area.

### **Relatedness and diversification in EU and ENP countries**

**Ron Boschma and Gianluca Capone**

In this working paper we analyze the degree of relatedness between export products based on co-occurrence analysis (Hausmann & Klinger, 2007). We use the BACI Dataset (an elaboration from UN Comtrade Data), which guarantees ample coverage of ENP countries over time, at the 4-digit classification level. Our results show that in both EU and ENP countries the evolution of the export mix is strongly path-dependent: countries tend to keep a comparative advantage in products that are strongly related to their current productive structure, and they also diversify in nearby products. However, this effect is much stronger for ENP countries, signalling their lower capabilities to diversify in products that are not very near to their productive structure. Moreover, we also show that the future exports structure of countries is affected by imports: both EU and ENP countries keep a comparative advantage in products that are strongly related to their imports, but only EU countries show also evidence of learning to diversify in new products from related import sectors.

**Origin of FDI and domestic productivity spillovers: Does European FDI have a 'productivity advantage' in the ENP countries?****Vassilis Monastiriotis and Mireia Borrell**

The paper seeks to examine the distinctive impact that foreign direct investments of EU origin have on recipient countries in the EU neighborhood (vis-a-vis investments from elsewhere in the world). We look in particular at two types of effects: productivity spillovers (i.e., the impact of European FDI on the productivity of domestic firms) and regional disparities (i.e., the spatial concentration of European FDI in the recipient countries and the regional variation in the spillovers produced). Both of these effects influence directly the efficiency of the domestic production systems and the productive capacity, at large, of the economies concerned. In that sense, the question examined in this paper has a dual relevance, being important both in analytical and in policy terms. Analytically, it allows us to understand the extent and spatial structure of technology transfer, either directly (e.g., through supply-chain links) or indirectly (e.g., through competition and mimicking effects), from EU firms to countries in the EU neighborhood. In policy terms, it allows us to evaluate the economic efficiency of the process of political-institutional approximation and preferential economic integration between the EU and the countries belonging to the ENP region. For example, if productivity spillovers of EU-originating FDI are found to be systematically lower than those of FDIs originating from other regions, this would put in question the economic rationale of the process of 'EU approximation', as a policy choice for the ENP countries. Inversely, if the spillovers are found to be disproportionately positive, this would suggest a distinctively important role of the 'EU approximation' process for the economic development of these countries. To examine these issues we make use of two international firm-level datasets that have been used widely in the relevant literature (Orbis and BEEPS). We follow the literature in adopting a production-function approach and regress firm-level productivity on a set of firm-level and area/sector characteristics, including the share of EU FDI in the locality/sector. Together with the effects of 'origin', we also estimate –and control for– a series of other effects, such as absorptive capacity, size, technological distance, etc, as is standard in this literature (see, inter alia, Javorcik, 2004, AER; Gorodnichenko et al, 2007, IZA; Monastiriotis and Alegria, 2011, RevDevEcon).

**What drives European multinational firms to ENPs? A case-study analysis of two large multinationals****Andrea Ascani, Riccardo Crescenzi and Simona Iammarino**

A key element in the analysis of economic integration between the EU and Neighbouring Countries (NCs) is related to the study of the patterns of capital mobility between the two areas and, particularly, from Europe to the NCs. Understanding what are the motivations behind multinationals enterprises' (MNEs) behavior is relevant not only because they might generate employment and wealth in recipient countries, but also because they can play a role in the technological upgrading and internationalisation of domestic firms. The empirical question we attempt to address in the paper is related to the factors underlying the location strategies adopted by European multinational firms in NCs. In this work we adopt a qualitative perspective in order to grasp the complexity of strategic considerations that are internal to the firm and that eventually drive localisation decisions. The aim of the paper is therefore to gain in-depth insights on the drivers of location and on the interactions of MNEs with domestic actors. The paper is based on firm-level case studies of two of the largest Italian-owned multinational enterprises operating in the NCs area. Interviews collected at the level of Headquarters with top level managers were complemented by documentation available on the web and provided by the firms themselves. The information gathered allows exploring the strategic behavior of MNEs in NCs, unveiling aspects not captured by quantitative analyses.

**Location choices of multinational companies in Ukraine****Daria Zvirgzde, Daniel Schiller, and Javier Revilla Diez**

There has been a wide acknowledgement of the role of foreign direct investment (FDI) for economic growth and development of states, regions and cities. Special attention has been paid to FDI flows to transition economies, which owe their economic and social transformation to a large extent to multinational companies (MNCs) which introduce knowledge, technology and new opportunities into these emerging markets. FDI flows from developed countries towards emerging economies become an important transmitter of economic resources and serves as a catalyst for development and attraction of further investments. While the role of FDI for

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economic growth of countries has been discussed quite comprehensively in the literature, the regional level and the factors behind the geographical distribution of FDI at the sub-national level have not gained sufficient attention. The factors that attract MNCs towards certain markets and economies are unevenly distributed among countries and regions. The range of specific host region determinants for the attraction of FDI is generally divided into two broad groups: traditional economic factors and institutional factors. Traditional economic factors are based on the systematic conceptualisation of FDI location choices by Dunning (1993) in his eclectic paradigm OLI, which stands for ownership, location and internalisation advantages. The relevance of the institutional perspective for location choices of MNCs has gained a much wider audience recently. It focuses explicitly on the embeddedness of firms into local institutional environments. Foreign firms become highly dependent on the institutional factors at the chosen location for investment and have to adapt themselves (at least to a certain degree) to the local institutional framework in order to gain legitimacy and integration within the regional economic system. The aim of the paper is to identify determinants of location choices of FDI in transition economies, based on empirical evidence of an enterprise survey carried out in three regions in Ukraine within the project "SEARCH: Sharing knowledge assets: interregionally cohesive neighbourhoods" funded by the European Union within the Seventh Framework Programme for Research (FP7). By and large, the paper contributes to the provision of a thorough theoretical framework on location choices of MNCs by integrating the institutional component and provides empirical results on (1) traditional economic factors that attract FDI to certain localities within transition economies, specifically Ukraine and (2) institutional and proximity parameters of regions that attract or distract MNCs in order to determine the impact of the institutional environment and proximity advantages of certain regions on the propensity of foreign firms to invest in certain regional host markets.

#### **Integration with the EU and regional inequalities in the ENP countries**

**Ageliki Anagnostou, George Petrakos and Maria Tsiapa**

A growing body of literature indicates that the process of economic integration may be associated with increases in regional inequalities (Kallioras and Petrakos 2010, Fotopoulos et al 2010, Petrakos et al 2011, Petrakos et al 2012). Higher levels of competition - especially imperfect competition - are deemed to result to an uneven distribution of the benefits of economic integration, increasing spatial imbalances. The impact of economic integration on regional growth depends on the development level and the ability of regions to compete successfully in order to capitalize from the opening up of markets. More advanced and competitive ENP regions are expected to benefit more from economic integration, while less advanced regions may even experience a net loss. Engaged in an integration process with more advanced and, possibly, distant partners, less advanced regions in ENP countries tend to develop unbalanced, inter-industry type of trade relations with a possibly unfavorable impact on their productive bases. This paper reviews the literature and the experience on the evolution of regional inequalities in the Transition countries that experienced in the post-1989 period the opening up of their markets during the process of orientation of their economies towards the EU. The paper also analyses the evolution and the patterns of regional inequalities in ENP countries and sets up an empirical model following Petrakos et al (2005) in order to evaluate the impact of EU-ENP integration on the evolution of regional inequalities in ENP countries. Based on the analysis of regional data and the findings of the empirical model, the paper discusses implications for balanced development.

#### **The effect of EU foreign direct investment on regional equality in the European Neighborhood: Evidence from Israel**

**Michael Beenstock, Daniel Felsenstein and Ziv Rubin**

Typically regional FDI data is notoriously difficult to obtain. In this paper we suggest a methodology for estimating the effects of FDI on regional inequality without recourse to data on regional FDI. Specifically we investigate whether foreign direct investment causes FDI causes regional polarization in the neighboring (ENP) countries. Theoretical and empirical ambiguity characterizes this issue. Evidence exists that FDI both exacerbates regional differentials in host countries and stimulates their convergence. Using Israel as a prototype, we illustrate an empirical strategy for estimating the regional effects of EU FDI. We apply a two-stage approach. In the first stage, we estimate regional wage differentials as driven by Marshallian agglomeration (where the cumulative experience of human capital rather than demographics is critical) and the capital-labor ratio. Together these factors

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drive productivity and wages. In the second stage, we model regional capital stock as a function of national FDI stock, regional incentives, regional population and regional human capital. In this way we estimate the effect of FDI on regional inequality through the capital stock. We use the model to decompose regional wage inequality into the effects of FDI, regional incentives and agglomeration. Our results show that the short run impact effects of FDI on capital stock are substantial in most regions and in some peripheral regions outweigh the effects of regional incentives. The impact of FDI on regional earning variation is smaller and more circumspect but still positive in most regions. We investigate spatial spillovers by measuring spatial autocorrelation across regions and over time. We also test for spatial spillovers in the transmission of regional equality using spatial panel data econometrics. Given suitable regional data, this approach can be replicated for other ENP countries.

### 3. PAPERS THAT WILL NOT BE SUBMITTED TO EPC SPECIAL ISSUE

The aforementioned papers are going to be included later on in the deliverable, upon their submission to EPC. For the time being, the deliverable contains a paper which will not be included in EPC. This paper is the following one:

WP2/18: Trade activity between the EU and its neighboring countries: Trends and potential (authors: Dimitris Kallioras and Anna Maria Pinna).

WP2/18 examines whether trade activity intensifies over time as the outcome of signed bilateral trade agreements. Focusing on (the trade component of) the European Neighborhood Policy, the paper conducts an in-depth study of trade activity between the EU and its neighboring countries, attempting to offer a detailed analysis in terms of trade patterns and to investigate whether proximity is combined with higher trade flows, within the framework of a free trade agreement. The analysis utilizes data derived from BACI database and covers the period from 1995 to 2011. The findings of the paper indicate that there is a lot of potential for the expansion of trade activity between the EU and its neighboring countries and accentuate the crucial determinants in this direction.

The paper has been submitted for publication to "Tijdschrift voor Economische en Sociale Geografie", in a special issue edited by Professor Ron Boschma (URU), Professor Simona Iammarino (LSE) and Professor Raffaele Paci (CRENOS). The working paper has a Policy Notes addendum i.e. a 2-3 pages text consisting of 3 parts: a) objectives of research in reference to policy; b) scientific/research methods; c) policy value-added. Later on, more papers are going to be included in the deliverable.



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