Economic integration, border costs and FDI location: Evidence from the fifth European Union enlargement

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ABSTRACT

Little is known about the effect of border costs on FDI location. This paper explores this for the fifth European Union (EU) enlargement that integrated the ten Central and Eastern European countries (CEECs). It regresses count data for 35,105 FDI projects locating in 25 European countries over the period 1997–2010. Four EU accession events are examined for the more- and less-liberalized CEECs. It finds that the lower border costs doubled FDI in the CEECs at EU membership, of which 60% is diverted from the ‘old’ Europe. This membership effect is three-times greater for the more-liberalized countries, for which earlier accession events are unimportant.

1. Introduction

There is considerable research on how border costs affect trade (Anderson & van Wincoop, 2003; Coughlin & Novy, 2009; McCallum, 1995), but relatively little on how these costs affect foreign direct investment (FDI). Standard theory predicts that horizontal FDI is discouraged when trade costs fall, but Neary (2008) notes that this conflicts with recent experience where trade liberalization is associated with a strong increase in FDI. A major reason for this is the formation of trade blocs, with firms establishing greenfield plants abroad as low-cost export-platforms (see Ekholm, Forslid, & Markesen, 2007; Krugman & Venables, 1990). Integration may also lead to brownfield FDI if a multinational enterprise (MNE) consolidates its plants (Neary, 2008). Despite this theory, there is little empirical evidence on how border costs affect FDI location. This paper remedies this deficiency by drawing on the experience of the fifth enlargement of the European Union (EU) to examine how the lower border costs affected FDI location. This enlargement added more than 100 million citizens to this trade bloc from the ten countries of Central and Eastern Europe (the ‘CEECs’), creating the world’s largest single market (Egan, 2015)1.

The enlargement removed the internal border checks for the new accession countries in the form of waiting time and administrative costs (Hornok, 2008). These are difficult to measure, but in aggregate they are estimated to be around ten per cent of the trade costs of the CEECs with the ‘old’ Europe (Edwards, 2008). Membership did not involve substantial tariff reduction, as these were agreed under the earlier Association Agreements, while the technical and non-tariff barriers (i.e. regulations and product standards) also did not

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1 The CEECs are the ten former communist states that joined the EU in 2004 and 2007, i.e. mainly Eastern Bloc countries west of the former Soviet Union, plus the Baltic States. The former Yugoslavia was not part of this Bloc, but Slovenia joined in 2004 and so is included. Croatia joined in 2013 and is not included.

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change sharply at this time. The accession process lasted up to seven years from the start of negotiations until EU membership and the economic and political liberalization of the CEECs was integral to this. This poses a threat to identification but the approach of this paper is to focus on key accession events and to examine these for more- and less-liberalized CEECs. From this it is possible to infer that the effect of the lower border costs occurs at membership. In particular, if EU membership is just a commitment to future liberalization then we would expect a larger effect for the less-liberalized countries. Further, if FDI locates to anticipate the lower border costs at membership then we would expect the earlier accession events to be important.

The FDI data are sourced from the European Investment Monitor, which is compiled by Ernst and Young (see Defever, 2012). This comprises information on 35,105 cross-border investments locating in the ten CEECs and fifteen incumbent EU Member States (‘EU15’) between 1997 and 2010. These are greenfield and brownfield FDI, where the latter is a re-investment by a MNE at its existing plant. The data are analyzed as project counts for each country and year using a fixed effects panel regression for the twenty-five countries (‘EU25’). Four accession events are examined: the commencement of negotiations; the European Council commitment to enlargement; the conclusion of negotiations at which the membership date was announced; and EU membership. These are evaluated separately for the more- and less-liberalized CEECs, where these entered the accession process at different times owing to their different levels of liberalization. A contribution of the paper is to examine the extent to which the FDI location is diverted to the CEECs from the EU15. It involves regressing a log-linear model for both the share and level of projects. The error structure allows for the smaller level of FDI in the CEECs and for the possibility of any inefficiency in data collection in the CEECs prior to the accession negotiations.

Overall, the paper finds that EU membership had a substantial effect on the FDI in the CEECs, more than doubling the number of the projects locating in these countries compared to before the commencement of the accession negotiations. As other changes to the trade arrangements were relatively unimportant at this time then it is due to the lower border costs from the removal of border checks that led to a reduction in waiting time and administrative costs. The FDI effect varies with the liberalization of a country, so that the increase in FDI location is three-times greater for the more-liberalized CEECs. It is also greater for less-liberalized CEECs in the run-up to membership, which is consistent with their liberalization under the enlargement process. The net effect of FDI location for the EU is much smaller as 60% of the projects in the CEECs at membership were diverted from the EU15. Nevertheless, despite its effect depending on the level of liberalization, the lower border costs had a substantial impact on FDI location in the CEECs.

The next section describes the key accession events and the nature of the border costs. Section 3 discusses the empirical framework and Section 4 outlines the nature of the FDI and other data. Section 5 presents the regression results and Section 6 concludes.

2. EU accession and the border costs

Following the collapse of communism a formal set of criteria for the EU membership of the CEECs was set out in June 1993. These are the Copenhagen criteria that embody conditions related to political and economic liberalization (Christoffersen, 2007). The criteria for the political liberalization of a CEEC had to be satisfied before the negotiations could commence with it, whereas the economic liberalization measures had to be implemented by membership and enforced thereafter, so these were part of the negotiations. Applications for membership were received from the CEECs over 1994–96, and four key accession events are identified in Table 1. The events vary in their timing according to a three-fold classification of the CEECs that is the same grouping used by Bevan and Estrin (2004), except that Slovenia is included. The groups also differ by their liberalization, which is useful for our identification strategy.

In relation to liberalization, the CEECs were screened in the run-up to a 1997 Luxembourg Summit of European Ministers, and following this the negotiations commenced with five of these, which (with Cyprus) were known as the Luxembourg Group (Table 1). The other five CEECs were judged to be not sufficiently liberalized either to satisfy the economic criteria in the medium-term or in the case of Slovakia on the basis of its political liberalization, so that these are the less-liberalized countries. Their negotiations followed a 2000 Helsinki Summit, and (with Malta) they were known as the Helsinki Group. As regards the accession events in Table 1, a 2000 Road Map sped-up negotiations with some of the Helsinki Group, such that a commitment to enlarge was made at a 2001 Laeken European Summit (Christoffersen, 2007). This approved plans to bring the negotiations with eight of the CEECs to a close by the end of 2002. A further European Council meeting announced that enlargement would take place in May 2004. A timetable was agreed for Bulgaria and Romania, and at the Brussels Council meeting in December 2004 it was announced that they would join in 2007 (see Table 1).

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2 The political criterion concerns a stable institutional set-up to guarantee democracy, rule of law and protection of human rights, whereas the other two criteria relate to a fully functioning market economy and the acceptance of EU law, but which together correspond to economic liberalization (Rode & Gwartney, 2012). In the run-up to negotiations the 1994 Essen Pre-Accession Strategy helped the CEECs prepare for the Single Market through structured relationships with the EU’s institutions and the gradual adoption of EU law.
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