Int Adv Econ Res (2009) 15:488–489
DOI 10.1007/s11294-009-9223-x

RESEARCH NOTE

FDI Inflows in the EU-15 and the Role of Structural Funds

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Published online: 4 July 2009

During the last three decades there has been an impressive increase in global FDI (Foreign Direct Investment) flows. Almost half of the flows towards developed countries have been directed towards EU-15 countries. Since the empirical investigation has confirmed the positive impact of these inflows on growth and development, economic research has recently focused on the factors that make a country an attractive FDI location.

Among the most significant FDI determinants have been market size, market potential, labor costs, agglomeration effects, openness of the economy, macroeconomic stability, quality of infrastructure, human capital and quality of domestic institutions. EU structural funds (SF) have been used to create growth and improve the quality of infrastructure, human capital and domestic institutions of the receiving countries, thus, making them a more attractive FDI destination.

The purpose of this research is to investigate the extent to which SF achieved the above targets and have contributed to an increase in FDI inflows for the receiving countries. Using panel data that covers seven five-year periods from 1970 to 2005 for 13 of the EU-15 (Luxemburg and Germany were excluded for data reasons), we tested the statistical significance of market size and potential, agglomeration effects, unit labor costs, openness of the economy, macroeconomic stability, real effective exchange rate, human capital, institutional quality, corruption, and structural funds.

Utilizing a variety of econometric techniques appropriate for panel data (fixed and random effects, OLS and GMM estimators), we find results that are robust to these alternative specifications and consistent with previous studies. Market size, growth, unit labor cost, agglomeration effects, macroeconomic stability, and the quality of institutions appear to be important determinants of FDI inflows. Furthermore, for countries with high quality institutions the EU SF have a positive impact on FDI, while for countries with low quality institutions the impact can be negative.

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The negative impact of SF on FDI should be interpreted with caution. There is no doubt that corruption and poor institutional quality affect growth inversely. However, SF is significant in a regression where growth, institutional quality, and country effects also appear as explanatory variables. The analysis suggests that for countries with high institutional quality, SF reinforce their comparative advantage, while for countries with low institutional quality SF leave countries worse off.