Trade costs and the pattern of Foreign Direct Investment: evidence from five EU countries

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According to the theoretical models of the multinational enterprise, trade costs play a fundamental role in determining the pattern of foreign direct investment (FDI). The aim of this paper is to assess the impact of trade costs on the outward and inward stocks of FDI of the EU. We estimate a model based on the knowledge-capital theory of the multinational enterprise over the period 1995-2008 by using a sample of five EU countries and 26 partner countries. We consider, first, manufacturing sector as a whole and, then, six manufacturing industries defined at the two-digit level of the NACE classification. Explanatory variables include a direct measure of trade costs (i.e., bilateral applied tariffs), and a dummy to capture the presence of Bilateral Investment Treaties (BITs). A dynamic panel model is estimated through the generalized method of moments (GMM) estimator, taking also into account the heterogeneity bias and the endogeneity of regressors. The results show that that the pattern of the outward FDI is a mix of vertical and horizontal FDI. BITs in force have a significant and positive impact on the outward FDI. The impact of tariffs varies across industries, suggesting the predominance of horizontal FDI in some industries and the existence of vertical FDI in others. Estimates also indicate that the stocks of the inward FDI of the EU countries are mainly driven by similarity between countries in the labour skills while tariffs have not been found to exert any influence.