Contributions to Economics

Christos Nikas *Editor*

# Economic Growth in the European Union

## Analyzing SME and Investment Policies

# Contributions to Economics

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Editor

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## Analyzing SME and Investment Policies

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# Foreword

## European Union Funding Instruments and Juncker Plan for Entrepreneurship Development

Trying to understand and analyze this complex issue, a first distinction needs to be made. The funding instruments of the European Union fall into two general categories. Firstly, there is the category of subsidies to which most people are familiar with the National Strategic Reference Framework (NSRF) and other European orientation programs such as the SME Instrument.

The second category is the one of funding instruments, on which I will give a little more ground due to the fact that, in my opinion, it is perhaps of greater interest to Greece, but also because it seems to be more dynamic at the European level. This category, in the broad sense, also belongs to the European Fund for Strategic Investments (EFSI), which is the cornerstone of the Junker Plan on which I will elaborate below.

The instruments used in this category to support entrepreneurship are mainly loans and guarantees.

The first thing ought to be analyzed briefly is the introduction of the National Strategic Reference Framework (NSRF) as the first pillar of entrepreneurship financing. However, it should be pointed out that things are not so good in terms of boosting entrepreneurship. Despite the Greek government's triumphs over absorption at the end of 2016, which of course can be disputed, I am personally witnessing a great deal of market concern about whether money has flowed into the real economy.

And I would like to emphasize that beyond the numbers which, as I said, I do not dispute, the overall picture of absorption of the National Strategic Reference Framework may seem to be achieving its objectives, but the Competitiveness, Entrepreneurship and Innovation Operational Program, which is the program that finances entrepreneurship, is the last in performance of all operational programs, including Regional Operational Programs.

So I am coming to another, hopefully more optimistic and useful part, the purely European funding tools to support entrepreneurship.

First is the SME Instrument, which is funded by the EU's Research and Innovation Support Program, Horizon 2020. With 3 billion euros in funding for the period 2014–2020, the SME Instrument helps small and medium-sized enterprises develop innovative ideas for products, services, or processes to cope with global competition. This program has shown the way for SMEs to finance innovation through gradual and progressive funding.

It is worth noting that this program operates at a global-European level and the competition is enormous as Greek companies now compete with their respective Italian, German, Bulgarian, and Romanian companies, respectively.

The program operates in two distinct phases of funding.

In the first phase, business ventures are funded to evaluate their viability. These can be either startups or new products or services for existing ones. The money given at this stage is relatively small, at 50,000 euros, but the process is quite fast so it is worth a try.

In the second phase, business-tested proposals are funded that may need further support to gain critical mass or make a product commercially viable in a new market. The money here is in the range of 500,000 euros up to 2.5 million—or more—and the amount of funding can go up to 100%.

This tool has achieved considerable success and is highly competitive, but I would say that it is worthwhile to hire an entrepreneur primarily because it gives the prospect of competition at a European level, something that any company will be asked to do sooner or later in one way or another.

I conclude here the first part of the presentation on the so-called grants.

I will tell you now something that has been starting to be discussed openly in the chambers of the European Parliament, instead of the corridors where it started.

Contrary to what we were once told, there is no money, and not only that, and what we probably have is not enough. So we have to do more with less. And this is something that will undoubtedly affect the way Europe finances entrepreneurship.

So sooner or later there will be an end to subsidies. Taxpayers' money should be refunded immediately and returned for reuse.

So they have to mobilize money from the private economy. Financial instruments such as the European Fund for Strategic Investments which is one of the pillars of the famous Juncker project should, therefore, be used.

The commission works together with its strategic partner, the European Investment Bank Group. The EFSI supports strategic investments in key areas such as infrastructure, energy efficiency and renewable energy, research and innovation, environment, agriculture, digital technology, education, health, and social projects. It also helps small businesses to begin operating or producing, to grow, and to expand by providing risk finance.

In terms of numbers, while the initial target was EFSI to mobilize around 315 billion by 2018, due to its excellent performance, it was decided to be extended and further financed and is now expected to mobilize over 2020 500 billion euros (Commission Regulation 2015/1017).

According to the latest May figures, 36.9 billion of EFSI-approved financing is expected to mobilize investments of 194 billion euros, of which almost 30% relates to small and medium-sized enterprises and so far has benefited over 385,000 small and medium-sized enterprises.

Here are some very recent examples of supporting entrepreneurship from other countries through the Juncker project.

A few days ago it was announced that in Romania, under the EFSI, the European Investment Fund has concluded a financing agreement for SMEs with three banks, which is expected to create credit lines of 246 million euros and directly benefiting over 4300 small and medium-sized enterprises.

Another example, directly funded by EFSI, comes from Germany, where a 20 million loan was given to the biopharmaceutical company "Biofrontera" to develop innovative skin cancer treatments and medicines.

Finally, an example of the utilization of the European Fund for Strategic Investments comes from the Netherlands where this time around 150 million euros were mobilized in cooperation with ABN AMRO Bank to implement a green retrofitting program, namely the reconstruction of Dutch ships in more environmentally friendly terms.

Having said that, I do not mean that things are not going well in Greece or that the European Fund for Strategic Investments does not have success stories in our country either.

But since the enemy of the good is the best, and because it is useful in politics not to reinvent the wheel every time but to see what others are doing near us and whether we can duplicate good practices, I thought it appropriate to give you these typical examples so that they may be able to give rise to further discussion.

European Parliament, Brussels, Belgium Maria Spyraki

# Foreword

## The Juncker Plan and the Opportunities for Greek SMEs

The Chamber of Commerce and Industry of Thessaloniki and I are very proud for the co-organization of the conference entitled "EU Investment Policies—The Investment Plan for Europe (Juncker Plan)" with the Jean Monnet Centre of Excellence of the University of Macedonia.

In this edited volume, the contributors extensively present the conception of the Juncker Plan. This might open the way in order to better understand the proper functioning of this plan. My contribution is an effort to answer the question of the extent to which the Juncker Plan can be an opportunity for Greek people, and especially Greek small and medium-size enterprises (SMEs henceforth).

It is important to start with an anecdotal evidence about what President Truman of the USA said about economists. When he took office, in 1945, he asked his Chief of Staff to recruit a person as an economic advisor, and he added: "*I want to have a one-handed economist*." "*What does this mean, one-handed economist?*," the Chief of Staff replied, "*we know that there are classical economics, the Keynesian economics, the Marxist economics but only with one hand?*" President Truman, a person with experience in this difficult field of economics, since he was a failed businessman in the 1920s, as he went bankrupt, insisted by reasoning "*when I ask an economist for an advise, he always says this, this and this, but then always adds that on the other hand*. . ., *so please, ask for an economist that has only one hand*."

What does it mean? It means that in our profession, in economics, a very usual situation we face is that there are unintended consequences of actions and maybe this makes forecasts and predictions more difficult. The approach of politicians or of businessmen is not of great importance here, as a businessman would be very enthusiastic in the beginning, analyzing the details of the Juncker Plan, but as he reviews his own business plan, he understands that he can only make a limited use of the plan.

Nevertheless, the Juncker Plan is a very important instrument that will be explained extensively in the next chapters. I am personally very influenced by the

strain of economics thought what is called "evolutionary economics" and has not that much to do with classical or Keynesian economics, but it looks after the real economy and its foundations. I certainly consider the creation of favorable conditions as an opportunity. But allow me to wonder, given the limitations, at the extent to which Greek SMEs can make use of this opportunity.

How the provisions of the Juncker Plan can be materialized by Greek SMEs? We need to turn back to evolutionary economics, and it can be explained by using an example based on the population of deer. A herd of deer is living in an environment where wolves constitute the dominant risk and another herd is living in an environment where avalanches are the most important risk factor. In the first case, after many centuries the deer which have a great advantage in speed, running away from wolves, will survive and they will be replicated and reproduced. So, the average velocity of the herd will increase. In the case of avalanches, the risk of being too fast is higher than the risk of not being so fast, so after many centuries, the average speed of the population will decrease. The two herds had the same initial characteristics, but due to the environment and the conditions being different, after many centuries their reproduction will be diversified.

What happens when a sudden change of environment occurs? Consider the fact that a change to the climate might occur and the place where avalanches were the dominant risk factor is not anymore as much affected, and avalanches are not happening at the same frequency as in the past and now this environment also attracts wolves. Wolves would have a feast with the remaining population of deer because they are not as fast as the first herd, and this can be used as an analogy that can explain the behavior of small and medium-sized enterprises in a closed environment. The skills developed in the past determine the present and that is evident in the case of Greece.

Which were the conditions in the past four years and especially in the decade before the financial crisis? There was great protection of small and medium-sized enterprises, a cocoon that has been created by the state, not with fiscal and financial policies, but in terms of monetary and credit policies. They created a huge domestic market, so small and medium-sized enterprises in Greece developed their skills according to this environment and, still, the majority of Greek SMEs are oriented to the domestic market, but now we face the impact of a sudden and severe crisis.

The economic crisis that started in 2009 for Greece hit the SMEs more severely than in other countries as these enterprises were not prepared for that kind of sudden change in their environment. It was necessary to develop new skills that will allow them to adapt to a global environment, to a globalized world, something difficult and not always obvious.

What are the skills that are required for competing in the global markets? The first basic skill is market intelligence. This is something that Greek SMEs are lacking of, and we have witnessed it in many occasions, and under different circumstances.

Secondly, for the majority of SMEs in Greece, the capacity of innovation is limited due to many reasons. The potential of innovation is still very limited and what is more important and makes things more difficult, even with this low potential

of innovative abilities, is that the penetration of innovation itself is very small. You can see that Greek consumers are reluctant in many cases, so are Greek businesses in adapting to new kinds of methods, in order to empower personnel in companies. Even in the bigger companies, this managerial attitude is not very well endorsed.

Thirdly, unfavorable conditions are established in other parts of the economic activity. For instance, there is bureaucracy, high burden of taxation, over-regulation, and very unfavorable politics in an area that cannot allow businesses to expand or to establish themselves in new spaces.

To summarize, it cannot be conceived that the Greek economy, the Greek political economy, and especially the political economy of SMEs will allow them to come again to a path of growth after the financial conditions have improved. This means that the expectations for greater response to financial stimuli will be shadowed. So, it is better to bear in mind that this response will be a limited one. To be sure, we have the very high burden of high unemployment rates, social unrest, unfavorable development concerning wealth, etc., all of that link to a deep structural crisis in the real economy and the resulting question is what kind of measures can be taken in order to alleviate these harsh conditions and what can be expected from the behavior of businesses. Since this is not happening, we need foreign direct investments as the key drivers for restructuring the Greek economy.

Our chamber is, for instance, supporting the idea for a platform that is called "Pro-Greece." Its aim is to bring together businesses from Germany and in order to give the latter the opportunity to work as subcontractors for the German ones. It is this kind of linkage that is missing, the inclusion to modern networks and the companies' abilities to operate themselves efficiently. Certainly, an improvement in the tax regimes, reduction of taxation, the improvement of the issues regarding corruption, and policies decreasing bureaucracy all are important factors that can contribute to a better environment for Greek SMEs, especially when they have a teaching function in order to make them acquainted with what is happening in the global economy.

It is not wise to assume that for every occasion the experience of successful economies around the world is directly applicable to the domestic markets of small countries. The USA, Japan, and probably China have this luxury. Greece, with almost eleven million habitants, needs to be compared to Denmark or Singapore in order to adopt the same pattern of politics rather than the pattern of politics in the USA, in Germany, or in other big countries. We have to look for improvement in the real economy rather than looking only after more favorable financial conditions.

It is also very important to assess what will be the reaction of the banking system in Greece, and also there is a link missing in that scheme. The banking system in Greece is very conservative and will not adapt very easily to the provisions of the Juncker Plan, as it should be expected under the condition of a proper and a more risk-oriented banking system. Due to the reasons mentioned above, although the Juncker Plan provides an opportunity for Greek SMEs, the materialization of this opportunity into practice will be a very slow process. This is what a reader should understand from this article: the fact that the process will be a slow one and so I remain very skeptical concerning the immediate impact of the Juncker Plan for Greek SMEs, but, at the same time, I am very optimistic about the long-term

prospects of the Juncker Plan for them. Finally, taking into consideration the constraints mentioned before, there is a great need for better preparation of SMEs and for the creation of an environment within the real economy that is more favorable to SMEs than the current one.

Chamber of Industry and Commerce, Emmanouil Vlachogiannis
Thessaloniki, Greece

# Acknowledgments – About the Jean Monnet Centre of Excellence

In this book, the Jean Monnet Centre of Excellence entitled “Research on Crucial Issues of European Integration” at the University of Macedonia, Greece presents the results of two conferences, a round table discussion and the research carried out within the framework of the Centre’s third research axis on “EU Growth” under the direction of its thematic coordinator, Professor Christos Nikas.

The Jean Monnet Centre of Excellence was established in 2015, after having been selected for co-funding by the ERASMUS+ Jean Monnet Action Program. It was hosted by the Institute of International Relations and European Integration of the Department of International and European Studies (IDEA) at the University of Macedonia, Greece, directed by Professor and Dean Ilias Kouskouvelis.

The main purpose of the centre was to conduct research on topical and crucial issues of European integration in five research axes: (1) the European Union in the international system: security and defense; (2) European economic governance; (3) the development of the European Union; (4) constitutional values, rights, and citizenship in the European Union; and (5) research, education, and youth policies in the European Union. Each axis had three research projects. Overall, 38 researchers participated in the research projects, most of them from the University of Macedonia, some from the Aristotle University of Thessaloniki, and some from other universities and research centers, both in Greece and abroad.

The research was enhanced by researchers’ study visits abroad and the organization of 18 round table discussions and conferences on the aforementioned topics with guest speakers. In addition, three summer academies on the EU Area of Freedom, Security and Justice, as well as a seminar and a webinar on hate speech, were organized. Moreover, the “Observatory of EU Constitutional Values” was established with the main aim of reporting and commenting on relevant EU legislation and case law.

I would like to thank all, on my part as academic coordinator, the distinguished speakers, each and every one individually, and all those who supported the Centre of Excellence in organizing all the conferences and events.

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Despoina Anagnostopoulou
Academic Coordinator of the Jean Monnet
Centre of Excellence

# Disclaimer

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# Contents

**Introduction** . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 1
Christos Nikas

**Part I International Growth Concerns**

**Economic Nationalism: Constrained and Fragmented, If Any?** . . . . . . . . 9
Yorgos Rizopoulos

**Digitalization: Disrupting the Business Models of Multinationals** . . . . . . 21
Konstantinos Axarloglou

**Part II EU Policies for Growth**

**EU Corporate Governance Framework: The Role of the EU Institutions** . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 35
Vasileios Koniaris

**The EU Digital Single Market and the Platform Economy** . . . . . . . . . . . 43
Despoina Anagnostopoulou

**SMEs and State Aid** . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 59
Eftychia Mouameletzi

**Funding from EU Structural Funds Towards SMEs: Findings and Suggestions on Increasing SMEs Financial Capacity** . . . . . . . . . . . . 69
Dimitrios Skiadas

**EFSI 2.0: The Extension and Enhancement of the European Fund for Strategic Investments as a Case Study for the Review of European Policies** . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 87
Ioannis Papadopoulos

**Foreign Direct Investment and Growth Causality in the EU Countries and in the Transition Economies** . . . . . 113
Nikolaos Apostolopoulos, Zacharias Dermatis, and Panagiotis Liargovas

**Part III Country Specific Analyses on Foreign Direct Investment and Economic Growth**

**FDI to and from the Russian Federation: A Case Study of the Western Balkans and the Role of the EU** . . . . . 127
Iulia N. Sushkova and Antonia Koumpoti

**Sovereign Debt Crisis in Greece and Its Relation with Foreign Direct Investment and Competitiveness in Greece** . . . . . 155
Aristides Bitzenis

**Sector Analysis and Economic Growth in Greece: The Domination of Tourism over Other Sectors** . . . . . 167
Konstantinos Spinthiropoulos, Christos Nikas, and Eleni Zafeiriou

**Immigration and Economic Growth: The Case of Greece** . . . . . 177
Anastasia Blouchoutzi and Christos Nikas

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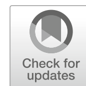
# Introduction




**Christos Nikas**

The volume "Economic Growth in the European Union: Analyzing SMEs and Investment Policies" in hand is designed to fill the gap in the literature on recent developments related to the restarting of the European economy towards economic growth. In this respect, it is a useful and important contribution to the research in this domain. The Euro crisis and the crisis of the Greek economy, in particular, have been a hot issue for the last 10 years, the problem being that the debate has taken place in political rather than economic terms.

There certainly is a vacuum in the literature regarding the policy aspects of the much needed economic growth. Most academics and politicians have focused on a blame game regarding what brought the crisis and how it could have been avoided. Viewing things from a positive, rather than a normative, perspective, the proposed publication follows a holistic approach to the issues, sectors and policies that a discussion and a policy agenda should include. Rather than going for depth, that is, focusing on one aspect of growth and coming up with a consensus among specialists of the same field of economics, this volume combines the approaches of different backgrounds and expertise in order to take into consideration as many aspects of growth as possible.

Concerning the conceptual and methodological issues of the volume, the restarting (or rather, awakening) of an economy after a long period of economic recession is a very difficult exercise both in terms of economic analysis and in terms of policy-making.

Moreover, new material is presented in the sense that very recent developments (the Juncker Plan, Digital Economy and FDIs, Nationalism and FDIs) are analyzed by papers in this edition. On the other hand, subjects such as the debate on the sectors

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of strategic importance for the Greek economy and the migration issue, although not new, have resurfaced as contemporary topics in the growth agenda and need to be addressed accordingly. Furthermore, there are references on policy measures adopted by the successive Greek governments which have, to a large extent, been dictated by the "Institutions" (or "Troika", as it is best known) and which were largely interpreted as a meaningless exercise. As a result, there has been very little (if any) discussion on the "day after" the memoranda.

The book is divided into three parts. The first, entitled "International growth concerns" includes two chapters.

Rizopoulos, in his chapter "Economic nationalism: Constrained and fragmented, if any?", examines the concept of economic nationalism and the possibilities of pursuing nationalist policies in the context of increasingly interdependent economic processes. He clarifies that economic nationalism should not be exclusively associated with protectionism. He illustrates that very few states dispose of the necessary economic, social, political and institutional conditions to influence economic policy given the long-term tendencies that undermine nationalist wills (empowerment of supranational bodies, internationalization of production, deindustrialization) and concludes that, even for these states, the pattern of business/government relations will have a critical influence. Under these circumstances, nationalist-type policies would probably be fragmented by powerful constraints.

"Digitalization: Disrupting the business models of multinationals" by Axarloglou takes a modern and forward-looking approach to economic and business issues, identifying the emergence of new groups of multinational companies ("Digital MNCs") that create value for the global market place, as well as achieve rapid and exponential growth along with high capitalization. The chapter highlights the structure of the business models adopted, the structure of their assets, the strategies and the tactics they follow to penetrate the global economy. He concludes with proposals on the framework for investment policy to support the development of the digital economy through Digital MNCs.

The second part entitled "EU policies for growth" consists of six chapters.

The first one, authored by Koniaris and entitled "EU Corporate Governance Framework; The role of the EU Institutions", presents the stages of development of corporate governance of the European Commission by referring to Small- and Medium-sized Enterprises (SMEs) and their role in the Industrial Policy of the EU. Effectively, the industrial policy is trying to ensure that enterprises and industries have access to resources, finance, skilled labour, energy and raw materials. The final aim is to promote a business-friendly environment, supporting the internationalization of EU enterprise and industrial goods and services and providing support for the protection of intellectual property rights.

Anagnostopoulou's chapter "Digital single market and the platform economy" refers to the EU strategies on the Digital Single Market and the Digital Agenda. These strategies have advanced EU growth with concrete actions, aiming at ensuring access and exercise of online activities for all individuals and companies without any discrimination in order to "unleash the potential of e-commerce". The contribution focuses on EU Regulation 2019/1150 "on promoting fairness and transparency for

business users of online intermediation services", which regulates the contract between the business user and the platform operator. Since the case for platform economy's benefits is still controversial, the chapter assesses whether the EU's attempt to control the immense power of the platform operators, most of them outside the EU, has struck the right balance between growth through new business models and fair competition.

The chapter "SMEs and State Aid" by Mouameletzi discusses the relation between small and medium enterprises and state aid. SMEs are very essential to promote competitiveness, job creation, economic growth, social stability and a spirit of entrepreneurship and innovation throughout the EU and thus, they constitute the major focus of EU policy, which aims to benefit them by granting them the SME bonus and therefore, more and easier State aid. It is important that an SME is properly classified as such, according to the provisions of the EU Commission, in order to have preferential access to state aid for investment and other activities. In this context, anti-circumvention measures have been established to prevent abuse of the SME definition and reserve the benefit of the SME bonus to genuine SMEs.

The issue of financing the SMEs is taken a step further by the paper "Funding from EU structural funds towards SMEs: Findings and suggestions on increasing SMEs financial capacity" by Skiadas. The author focuses on the financial support provided, in terms of both funding schemes and actual funds, by the Structural Funds to Small- and Medium-Sized Enterprises (SMEs), within the Cohesion Policy Framework. To this end, a special report of the European Court of Auditors is employed, focusing on the EU financial instruments for SMEs, which were co-financed by the European Regional Development Fund (ERDF). The findings of the reports are examined not only as evaluation results for the past, but also as crucial elements to be taken into account for the preparation of the corresponding actions of the Cohesion Policy within the 2014–2020 programming period.

The discussion on financing growth initiatives is broadened by the contribution of Papadopoulos "EFSI 2.0: The extension and enhancement of the European Fund for Strategic Investments as a case study for the review of European policies". Given the disinvestment crisis the EU is facing, the author analyzes the response in the form of the European Fund for Strategic Investments (EFSI). The chapter analyzes three basic points of the EFSI in enhancing governance and transparency, additionality, and geographical diversification. The conclusion is that the EFSI's strategy of risk-sharing has succeeded in crowding in significant additional finance, although its combination with a temporary and intelligent fiscal stimulus would be more efficient. Nevertheless, the downside of this relative success is that it has proven the important leveraging capacity of an increased use of financial engineering in a constrained fiscal environment.

Alternative sources of financing are brought into the discussion by the chapter entitled "Foreign direct investment and growth causality in the EU countries and in the transition economies" by Apostolopoulos, Dermatis and Liargovas.

The authors investigate the impact of FDI on the GDP in three groups of European countries: the European Union countries (EU-28), the Euro Area countries (EA-19) and the Eastern European Countries (EEC). The analysis is supported by

econometric investigation. In fact, an empirical model for this correlation was used to calculate the level of this relationship. The results reveal that FDI has a decisive impact on GDP, although it differs for each of the three groups of countries examined.

The third and final part entitled "Country specific analyses on foreign direct investment and economic growth" includes four chapters.

"FDI to and from the Russian Federation: A case study of the Western Balkans and the role of the EU" by Sushkova and Koumpoti discusses foreign direct investments in the Russian Federation, mainly after the imposition of the western sanctions, and uses the Western Balkan countries as a case study of Russian and European influence on their economies. The chapter also analyzes the soft power the Russian Federation exercises over the Western Balkans, based on influence and economic ties, as an answer to the EU membership perspective of those countries and the dual advantage the EU possesses since investments are made both from the EU and its Member States. Nonetheless, by focusing on strategic sectors, the investment policy of Russia is promoting its international stance, making its foreign economic policy of great importance in ensuring the country's global leading position.

Furthermore, on a country-specific level, Bitzenis, in his chapter "Sovereign debt crisis in Greece and its relation with FDI and competitiveness", presents the triple threat of the austerity policies imposed through the memoranda in Greece. The country performs poorly in the annual competitiveness surveys and a change in economic policy is needed in order to enhance competitiveness and attract FDI. The relatively low attractiveness of foreign direct investment inflows in Greece is illustrated and explained. The peculiarities of FDI outflows from Greece to foreign countries foresee positive externalities in the Greek economy.

"Sector analysis and economic growth in Greece. The domination of tourism over other sectors" by Spinthiropoulos, Nikas and Zafeiriou examines the impact of significant sectors of the Greek economy and their relationship with economic growth. Using econometric investigation and a multivariate self-regressive VAR model in particular, the long-term relationship between GDP and the examined variables is investigated for the long period of 1965–2015. According to the findings, the "growth engine" for Greece seems to be tourism rather than manufacturing, while a shift away from the tertiary to the primary sector is confirmed for recent years. The results provide policymakers with effective policy tools for the simultaneous economic growth of the two aforementioned sectors, since the horizontal imposition of heavy taxation during the recent crisis threatened to deprive Greece of its engines of growth.

The chapter by Blouchoutzi and Nikas, "Immigration and economic growth: The case of Greece", investigates some questions on whether immigration is advantageous for the economy of the receiving country. The chapter focuses on displaying the potential gains of immigration for Greece by presenting the "immigration surplus", that is, the economic benefits due to immigration. A neoclassical growth model is used assuming a competitive, market-clearing framework to measure the impact of immigrants in natives' earnings from 2001 to 2018. Moreover, the chapter

aims at exploring whether there is a long-run relationship between immigration and growth in Greece and estimates it using econometrics and the dynamic least squares method in particular.

The topics covered have theoretical and empirical merit. The material is structured and presented in a way that is friendly to the reader and forms the basis of a fruitful academic discussion on the issues covered.

I sincerely believe that there is substantial value added in research and conceptual terms in the contributions of the book, which makes the whole endeavour challenging and interesting in academic terms. The analyses are well-documented and not trivial and the multidisciplinary composition of the team of authors promises a global and comprehensive approach. However, the usual disclaimer applies: All errors remaining in the text are due to the editor.

# Part I
# International Growth Concerns

# Economic Nationalism: Constrained and Fragmented, If Any?

**Yorgos Rizopoulos**

**Abstract** In this contribution, the meaning of economic nationalism and the possibilities of pursuing nationalist policies in the context of increasingly interdependent economic processes are discussed. Economic nationalism need not solely be affiliated with statist protectionism, while very few states dispose of the necessary economic, social, political and institutional conditions to influence economic policy given the long-term tendencies that undermine nationalist wills (empowerment of supranational bodies, internationalization of production, deindustrialization). Even these states are not monolithic and the pattern of business/government relations in different fields would have a critical influence. Nationalist-type policies would probably be fragmented, followed in some specific domains under powerful constraints.

## 1 Introduction

A spectre is rising. The Economist, February 5th, 2009

Following the 2008 crisis, economic journals and specialized media repeatedly warn of the 'rising spectre' of economic nationalism. Indeed, trends of economic nationalism have crept into the economic policies and different states are taking measures supposed to promote the interests of national economies and to preserve their autonomy in an increasingly internationalized world. Such policies appear—and are justified—as a countermovement to the unrestricted mobility of capital, goods, and services and, to a very lesser extent, labour. A widespread feeling is that globalization favours and legitimates the interests of big multinational firms and of wealthy international elites, against those of the majority. Many studies—including those of international organizations as the International Monetary Fund (2008)—point out that globalization, financialization and neoliberal policies have increased

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unemployment and inequality (Dreher and Gaston 2008; Haskel et al. 2012) to such a degree that it is slowing down economic growth. Moreover, the operation of free markets has led to economic financial instability (Mendoza and Quadrini 2009). Even in rich states, persistent and institutionalized forms of poverty have appeared (Kiely 2005). National-interest-oriented policies seem to be the answer and President Trump asserts that protection will lead to prosperity and strength (CNN Politics 2017). But, does it make sense to talk about economic nationalism in the context of a world economy that is still heterogeneous but involves strong interdependencies between national economies? What could be its meaning, rational, forms and consequences?

As a first step, it is relevant to outline the conditions for pursuing comprehensive nationalist economic policies. Indeed, the definition and application of such policies imply some interlinked conditions. Among others, big and powerful countries with a high degree of sovereignty, a relative autonomy of national economic processes, social and political forces with strong bargaining power whose interests converge and crystallize at the national level, institutional arrangements enabling the coordination between the political and economic spheres, relevant administrative skills and a capacity for coherent action by the government. Very few countries meet these conditions and, even then, structural factors seem to greatly diminish the scope of nationalist policies. This inflicts to nuance the rhetoric concerning the 'spectre' of generalized commercial wars. The current desire to rebalance relations with internationalized capital is probably the backlash to an unbridled laissez-faire period, more than the manifestation of wide-range nationalist economic strategies.

Concerning the meaning of economic nationalism, many scholars put into question its assimilation with protectionism and statism (Cohen 1991; Shulman 2000; Helleiner 2002; Helleiner and Pickel 2005; Gonzalez 2010; Clift and Woll 2012; D'Costa 2012). Liberal policies may be motivated by national interests and quite a few historical examples show that free trade and national quest of power can go hand in hand. So, if there is any economic nationalism, a finer and more rigorous representation of its very essence is needed.

Furthermore, states can no longer be considered as monolithic entities (Rhodes 2007) and the business/government interactions on which the adopted policies depend are sufficiently differentiated in each issue-area (Brewer 1992; Grosse 2005; Levy and Prakash 2003; Bonardi and Keim 2005; Rizopoulos and Sergakis 2010) to generate diverse attitudes, or even inconsistencies, between policy-making domains. This means that ad hoc actions, depending on the ability of interest groups to highlight their specific concerns as national priorities, often substitute for economic policies serving a global project.

The chapter is structured as follows. In the next section, the meaning of economic nationalism is briefly discussed based on the teachings of the academic literature. Next are presented the factors that undermine the sovereignty of countries and the impact of differentiated business/government relation patterns in various issue-areas is underlined. It is argued that fragmented contingent measures are probably the current form of national interest-oriented policies. The last section draws some conclusions.

## 2 The Meaning of Economic Nationalism: Protectionist, Statist or Liberal?

> As American business and the American military move about the world, we are relearning the old wisdom that 'business follows the flag'. Our efforts to build security and your efforts to build prosperity have become increasingly synergistic—to the benefit of millions around the globe. When our diplomats and military forces combine to help create stability and security in a nation or region, that same stability and security attracts investment. That investment, in turn, generates prosperity. Cohen, W. S., US Secretary of Defense, Remarks at Fortune 500 Forum Dinner Keynote. Pittsburgh, PA (October 16, 1998)

Generally speaking, economic nationalism is the pursuit of national interests through economic means and it 'should be considered as a set of practices designed to create, bolster and protect national economies in the context of world markets' (Pryke 2012, p. 285). Its crucial element is that national identities should determine economic policies. However, this term is usually used in a narrower sense to describe statism and mercantilist policies; protectionism in the trade area (tariff and non-tariff barriers), industrial policy measures to subsidize key industries with either state finance or by using administrative measures and taxation, restrictions on the entry of multinational corporations preventing domestic firms from foreign competition, but also political pressure on domestic firms and shaping of the conditions in which private capital and market mechanisms operate. In other words, defensive protectionism is deemed as nationalism, free trade is not. This seems to be a bias.

When List (1966)—concerned with the interests of the (relatively weak) Germany—argues that protectionism ensures industrial development, that it has spill-over effects throughout the economy as it is the basis of military power and, as a consequence, states should direct and protect the economy for the good of the nation, this is obviously considered as nationalism. The objective is to accumulate wealth and enhance power given that relative national gain is more important than mutual or aggregate gain. Conversely, when Smith and Ricardo advocate free trade, they stress the harmony of interests not the dominance of the British industry over the rest of the world. *Laissez-faire* appears as favouring mutual economic benefit—at least from a static comparative advantage perspective—while List's protectionism or Fichte's 'closed commercial State' implies that cost–benefit analysis becomes a secondary issue concerning economic policy. Priorities are defined by national identity, eventually by bearing short-term economic costs for the building of latecomer national states, and their search for power in international relations.[1] However, free trade and mobility of capital may serve the interests of some (powerful) States or, more precisely, the interests of their economic, political and military elites. *Pax britannica* and, later on, *pax americana* are clearly an expression of economic nationalism in

[1]Debates concerning economic policy and the conditions of building the national State in the United States focus also on free trade versus restriction of imports, and isolationism (peaceful nationalism) versus expansionism. More recently, quite successful protectionist East Asian policies during post World War-II period (including the discouragement of foreign direct investment) lend support to the idea that economic nationalism involves necessarily protectionism.

the interest of the British Empire and the United States, respectively, as the above quotation of the US Secretary of Defense clearly shows.

Generally, nationalism is assimilated to statism, protectionism and costly self-interest attitudes, while free trade and capital movements are presented as liberal policies to enhance an open efficient world, bringing mutual benefits and wealth. Nevertheless, even during the nineteenth century, different views have been developed. For instance, Hegel's economic nationalism (patriotism) also departs from economic liberalism but involves international expansion and colonization/emigration (Nakano 2004b; Plant 1977). Later on, Lenin's analysis of imperialism points out the tight link between national interests of advanced states and a, usually violent, international expansion at the expense of weaker nations.

So, the first point to clarify is that economic nationalism does not always join protectionism. Nowadays, the aim of promoting local industries can lead governments to lift certain trade barriers and encourage foreign direct investment. Since the early 1990s, China has evolved away from concerns about protecting the home market toward favouring the expansion of domestically and internationally competitive firms. The obligations of WTO membership have actually pushed China toward a more sophisticated form of economic nationalism. Some authors talk about 'aggressive economic nationalism' (D'Costa 2012) to signify policies encouraging national businesses abroad. Also, in view of the difficulties caused by capital movement liberalization, most Asian countries, apart from Malaysia, instead of seeking capital controls, they chose to build up reserves through current account surpluses (Singh 2010). Encouraging national businesses abroad and liberalization of the markets may aim at increasing the power of the nation-state. Therefore, economic nationalism need not solely be affiliated with protectionism. Nationalist aspirations of autonomy, unity and identity can lead to both economic closure and openness (Shulman 2000). The crucial point is the reciprocal relationship between the political and economic power of the nation-state (Nakano 2004a).

Another interesting distinction made by the international economic relations literature is between protectionism which limits foreign presence in the domestic market and state interventionism which can merely provide aid to national companies without limiting foreign competition per se. In other words, conversely to the widespread idea that nationalist measures cannot occur in a liberalized market, economic nationalism should not be considered as a synonym of statism either. Indeed, some authors (Clift and Woll 2012; Helleiner 2002) distinguish two main forms of economic nationalism; classic protectionism and liberal economic nationalism. In their perspective, state interventionism does not appear to be a distinctive feature of closed economies, as it occurs in liberal openness policies that involve sustained state intervention. De-regulation, national rescue packages, bank recapitalizations and selective industry bailouts can be implemented. State interventionism and economic liberalism are not mutually excluded. Others, as Cohen (1991), distinguish 'malign' and 'benign' economic nationalism; malign nationalism seeks national goals relentlessly, even at the expense of others; benign nationalism is prepared to compromise national policy priorities where necessary to accommodate the interests of others. Another difference between these two types of nationalism

lies in the willingness of a country to identify its own national interest within the stability of the overall international system. Benign nationalism acknowledges a connection between self-interest and systemic interest; malign nationalism ignores or denies it. According to Helleiner and Pickel (2005), economic nationalism is a changing phenomenon. Discriminatory measures through making regulation stricter and liberalization of the markets could both be considered as indicators of economic nationalism if their motivation is to increase the power of the nation-state (Gonzalez 2010).

In this context, two aspects appear to be particularly important in assessing the chances of comprehensive nationalist economic policies; the sovereignty of nation-states and the pattern of business/government relations.

## 3 Undermined Sovereignty, Specific Business/Government Relations and Fragmented Policies

Commitment to the sovereignty of individual states is a necessary condition for economic nationalism which presupposes that a country has the will and the means to orient economic policy in a specific direction in order to realize a collective project, that it is democratically defined or not.

The International Political Economy school of thought (Mayall 1990; Gilpin 2001) argues that, in spite of globalization trends, the nation-state still remains a main player in the international political and economic order. This is what Gilpin (2001) calls ‘state-centric realism’. But, what could be the material base of nationalist economic policies today? By what strictly national means would it be possible to improve the position of a state in the international division of labour and in the international power games?

Some long-term global tendencies clearly undermine nationalist wills. Since the 1980s, capital markets liberalization and dismantling of state controls over capital flows, jointly with increasing sovereign debts, have largely shrunk the possibilities of pursuing independent national economic policies. Also, various international economic organizations are empowered to impose economic deregulation on states, regardless of whether they consider the measures to be in their national interest or not (Washington Consensus). At the same time, internationalization of production makes national productive systems dependent on the world economy. Moreover, the deindustrialization process in some rich countries weakens old national corporatism and favours the ‘internationalisation of the State’, according to the term used by Cox (1981). France is an example of this tendency. One interesting expression at the institutional level is that the ministries of labour and industry[2] which had built up in the context of national corporatism are henceforth subordinated to the ministry of finance which is clearly world-economy oriented.

[2]From 2017 there is no more ministry or state secretariat dedicated to the industry in this country.

Are there still countries sufficiently autonomous, with the appropriate social forces and institutional settings enabling the definition and deployment of nationalist economic policies? Apparently, they are very few. Some powerful states or big emerging countries involved in industrialization processes where influential interest groups have arisen may be tempted by nationalist policies, of protectionist nature (Russia) or not (China). However, even in this case, they act under powerful constraints.

President Trump's apparently aggressive positions strengthen the impression of a return to mercantilism and of imminent commercial wars. Meanwhile, if we suppose that the US administration ultimately imposes new tariffs unilaterally, ignoring the rules of the WTO, the cross-border activities of many American corporations would suffer. Indeed, the United States is very dependent on global value chains and a great part of American imports are in reality intra-firm trade of American multinationals, especially for complex engineering products such as aircrafts and cars. Favouring companies operating in the United States and penalizing the imports through tariffs and taxation policy may increase the employment of Americans in the short term but will also harm US firms producing abroad (and repatriating profits!) and benefit foreign firms producing in the United States. In a context where the national identity of businesses is blurred, fine-tuning by targeting some specific activities seems quite difficult to operate. The rise in tariffs for some products imported from China seems more like a way to create a position of strength in a global bargaining game.

Indeed, this policy is driven by geopolitical considerations, primarily the containment of the rapidly catching-up China, rather than an intention to isolate the economy of the United States. Given the central position that the United States still occupies in the world economy, such a priority will certainly have consequences on the structure of global value chains of the American multinational firms, implying relocations to some countries like Vietnam or India which are considered rivals of China. In addition, the repatriation of certain activities is likely, particularly if fiscal incentives are adopted, as was the case in 2018.[3] But even if these developments have a significant impact on the modalities of globalization and show that politics may still impose constraints to firms and their profit motives, this situation is by no means a generalized commercial war.

A related question concerns the economic and social forces that could agree on a nationalist political programme. An underlying assumption of economic nationalism is that the people forming a nation-state have common interests that transcend social divisions. However, social structure generates significant inequalities derived from ownership of assets, insertion to social networks, access to jobs, type of employment and levels of skill. Some interest groups may have sufficient bargaining power to impose discretionary nationalist policies generating private profits, while the majority of citizens do not benefit equally from them. As an example, the state could assume the entrepreneurial risks and facilitate the prosperity of certain businesses

[3] In 2018, the large-scale repatriations of accumulated foreign earnings by United States MNEs, resulted in negative FDI outflows (UNCTAD 2019).

that recover alone the profits without any spillover effects. Globalization has precisely accentuated social and economic differentiation (IMF 2008) and, as a consequence, social alliances to support comprehensive economic nationalism are generally weak.

Another critical point is that economic nationalism implies a strong coordination between economic and political actors and tight relations between firms and the state. Generally, business/government relations rely on multiple interactions and interdependencies. Firms try to legitimize their goals and use the state's coercive power in order to benefit from market failures, shape the rules of the game and, whenever possible, make political priorities match their own objectives. They deploy political strategies in order to receive support from governments. In return, governments obtain otherwise inaccessible resources through relations with firms (employment, intangible assets, external economic influence, etc.). Their links stand on this reciprocity balance and mutual resource dependency.

Many possibilities would exist between two polar situations. One is when the state acts as an autonomous actor and constraints the specific interests of the firms in the name of the national interest and the economic well-being for the majority, and the other is when the state puts itself at the service of the interest groups by justifying it as being in the country's interest to do so. In all cases, there is interaction, negotiation or even conflict, and this bargaining game can be assimilated to a bilateral monopoly with uncertain outcomes depending on the stakeholders' evolving power.

An additional element has to be taken into account. States are not monolithic. They become differentiated internally (Rhodes 2007), and business/government interactions are multifaceted (Grosse 2005) taking place at intermediate levels of government and policy networks (Rizopoulos and Sergakis 2010). Brewer's seminal work (1992) stresses the variety of business/government relationships across different issue-areas, Bonardi and Keim (2005) explain why interaction is situated at the issue level, while Levy and Prakash (2003) underline the differences existing between the state's interventions in different domains. The understanding of eventually nationalist economic measures implies the analysis of such contingencies.[4] Interest groups, bureaucrats and politicians interact within several fields, with varying influence and evolving bargaining potential determined by the specific historical context, institutional trajectories, specific economic interests and social constraints. One can hereby predict a wide range of stakeholders' relational patterns inside a single country and, as a consequence, diverse economic policy-making outcomes or even incoherence in government actions.

An approach in terms of issue-areas seems to be also relevant concerning economic nationalism. Given its economic and geopolitical situation, a country may be open in some areas and not in others. Economic nationalist-type measures are possible in some domains where even relatively weak states maintain a degree of sovereignty (because of their historical trajectory, institutional framework, etc.)

[4]For a stimulating analysis of this interactive process in Russia, see Yakovlev (2006).

and/or where powerful local actors with sufficient bargaining power succeed to legitimate their interests as being the national ones.

The recent evolution concerning attitudes related to foreign direct investment is an interesting example of the current forms of national interest-oriented policies.

According to UNCTAD (2018, p. 80), because 'most countries continued to actively attract FDI in 2017, and the share of investment liberalisation or promotion measures increased compared with 2016... the overall share of restrictive or regulatory investment policy measures has significantly increased in recent months and some countries have become more critical of foreign takeovers. Also, additional ways and means to strengthen investment screening mechanisms are under discussion, particularly in some developed countries... New investment restrictions or regulations for foreign investors were mainly based on considerations of national security, local producers' competitiveness or foreign ownership of land and natural resources'. Parallel to this renewed will to control FDI—especially incoming mergers and acquisitions—new models of Bilateral Investment Treaties (BIT) have been developed in order to provide greater protection for host countries and their ability to regulate multinational enterprises (MNEs), whereas previous treaties focused on the protection of MNEs. In particular, some countries have narrowed certain substantive protections of foreign investors, abandoned the umbrella clause and strengthened the essential security interest clause (which allows governments to disregard BIT commitments under certain circumstances).

Indeed, governments pay more attention to competing objectives and the consensus that all FDI is equally beneficial is changing as more governments consider (certain) mergers and acquisitions as less beneficial than greenfield investments. They may encourage more sustainable FDI, i.e. investment that makes a real contribution to economic, social and environmental development and takes place within mutually beneficial governance mechanisms while being commercially viable. Indeed, it is unclear how important BITs are to help attract FDI, while it is clear that they restrict the policy space of governments. States try to restore a certain balance in their relations with the MNEs in order to avoid the consequences of too much latitude on their part, whereas when economic activities involving national actors develop, the will to ensure the conditions of their growth can be reflected in the policies applied. Such evolutions may be interpreted as a kind of economic nationalism and political sensitivities or pressure from civil society may jeopardize some deals involving domains perceived as strategic at the national level. Meanwhile, investment liberalization is still among the prominent features of policy measures and there is no will that such decisions impede the flow of international investment. Even if we take the example of the restrictive policies related to foreign direct investment in some strategic sectors in Russia (Balzer 2005),[5] FDI inflows of this country remain at a high level in fast-growing non-sensitive private consumption

[5]In October 2005, Natural Resources Minister Trutnev stated that Russia should limit foreign participation in three main areas: scarce natural resources, large mineral deposits and fields close to military sites (reported in Liuhto 2008, p. 3).

activities. Also big deals occur in sensitive sectors, when foreign firms acquire minority stakes.

The main fact is that the growth of FDI brings new players into the global markets, and their competition is not welcomed by traditional players. Some nationalist-like measures are simply favoured by economic groups in order to protect their interests. From a historical point of view, this is a quite usual phenomenon. Thus, various contributions in the 1980s and 1990s (Bellon 1986; Porter 1990; Reich 1992) attempt to account for the state's economic commitment to the competitiveness of domestic firms, justified by the process of internationalization.

The same goes for the strategic trade policies deployed in order to affect the outcome of interactions between firms in world oligopolistic markets (Brander and Spencer 1983, 1985). At an applied micro level, Eden and Molot (1993) analyze the strategies of the Big Three US carmakers in order to influence political decision-making and reinforce their position as regards their Japanese competitors. Now, the only novelty is that considerations about 'sustainable' foreign investment are returning to the surface after more than two decades of *laissez-faire* and facilitation of international capital movements to the detriment of states' ability to influence the outcome of such movements. Some authors call this tendency 'a paradigm shift from laissez-faire liberalism toward embedded liberalism... a model whereby liberalization is embedded within a wider framework that enables public regulation in the interest of domestic stability' (Kalderimis 2010; Titi 2013).

## 4 Conclusions

After October 2008, a number of states raised tariffs, but, compared to historical experiences as the duties imposed on imports by the USA consequently to the 1929 crisis and provoking retaliatory measures across the world,[6] was not pronounced and systematic. Actually, the number of trade-restricting measures applied by governments has declined since 2009.

The calls of journalists, politicians and capitalists that there should be no return to protectionism are rhetorical rather than analysis-based. The dominance of international over national capital, international interdependencies, the internationalization of production blurring national identity of businesses, the internationalization and fragmentation of the state bureaucracies within the major countries (including the ongoing crossover of personnel between high finance and public administration), the empowerment of supranational organizations, the lack of cohesion between social groups which suffer from the negative effects of globalization—and as a consequence, their lack of political power—make that even in countries which historically were strongly involved into policies driven by the national interests we observe a process of abandoning global voluntarist projects. Currently, the United States

[6]By 1939, almost half of world trade was restricted by tariffs (Jones 2005).

conducts policies guided by geopolitical considerations which can have significant consequences on the modalities of globalization. However, in general, the material base for classic protectionism is undermined and the probability of thorough nationalist policies is low, even if there are possibilities of:

- A more balanced approach between openness and maintaining some bargaining power at the countries' level.
- Strategic policies and selective nationalist-type measures in specific domains, when the pattern of links between business interests, civil society organizations and state bureaucracies makes it possible.

Such policies may attenuate some negative economic and social consequences of globalization and, in this sense, they are even desirable from a normative point of view (Kobrin 2017). Meanwhile, few states seem able to define and apply such policies. In the contemporary international context, economic nationalism, if any, would be fragmented, constrained, and probably liberal.

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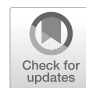
# Digitalization: Disrupting the Business Models of Multinationals




**Konstantinos Axarloglou**

**Abstract** In a Volatile, Uncertain, Complex and Ambiguous world, technology disrupts and globalization magnifies and propagates the dramatic changes in the workplace, in communications and transactions, and the way companies operate and create value. New groups of multinational companies emerge ("Digital MNCs") that create value for the global market place, achieve rapid and exponential growth along with high capitalization, where the growth of their assets is faster than the growth of their revenue and employment. The chapter sheds light on the structure of the business models these companies adopt, the structure of the assets they employ, the strategies and tactics they follow to penetrate the global economy and finally the framework for investment policy to support the development of the digital economy through Digital MNCs.

## 1 Introduction

In a Volatile, Uncertain, Complex and Ambiguous world (V.U.C.A.), globalization magnifies and propagates the disruptive changes of technology in the workplace, in communications, in transactions, and in the way companies operate and create value. The world is on the verge of a technology tsunami that transforms the way businesses are staffed, operated and managed. Smart robots, artificial intelligence (AI), the Internet of Things, increased global connectivity and computing power lead the way of the revolution (Brynjollfson and McAffee 2016). New business models emerge leading to a new group of multinational companies ("Digital MNCs"; DMNCs) that create value for the global market place, achieve rapid and exponential growth along with high capitalization where the value of their assets grows faster than the growth of their revenue and employment (UNCTAD 2017).

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DMNCs are classified into four groups (UNCTAD 2017): Internet platforms (all operation and sales are digital), digital solutions (e.g. digital payments, cloud-based service providers), e-commerce and finally digital content providers (e.g. video, music, e-books, data analytics). These groups of MNCs are exposed to digitalization (in terms of operations and sales) in a different degree than the companies that operate and sell entirely through the internet (e.g. digital solutions, internet platforms), or those that operate physically but achieve sales through the internet (telecommunication companies, e-commerce), or those that operate in the internet and achieve sales physically (IT companies).

## 2 Digital Technology: Business Models and Operations

The digitalization of DMNCs is affecting rapidly the various components of their value and supply chain including procurement, production and coordination across the network of suppliers, logistics and the interface with customers (Martin-Pena et al. 2018). Certainly, business models of non-digital MNCs are still resilient so their international footprint in terms of assets and their presence in foreign markets has only been transformed marginally. However, digitalization allows DMNCs to engage their customers directly, cutting off intermediaries (wholesalers and other retailers). This “direct model” allows DMNCs to collect massive data on customers’ behaviour and thus to customize better for their customers not only their products but also the portfolio of services they offer in enhancing their customers’ “shopping experience”. Furthermore, this disintermediation reverts emphasis on different components of the value chain, focusing now on production (concentrated in certain locations to take advantage of economies of scale) and on distribution and delivery (focusing thus on delivery partners on specific locations). DMNCs then transform the nature of their local affiliates from production to distribution and delivery (De Backer and Flaig 2017).

### *2.1 Digitalization and Operations*

Digitalization technology leads DMNCs to push and establish automation and robotics in production in an effort to achieve productivity gains (Loonam et al. 2018). The implementation of these new technologies increases fixed investment in certain locations and then DMNCs concentrate production in certain locations in order to take advantage of economies of scale and achieve the expected productivity gains. Moreover, highly automated and digitally enabled production supports greater product variety and customization. Production lines that are more flexible in terms of product allocations and manufacturing of multiple products allow more volume flexibility to meet seasonal or demand fluctuations. Several emerging manufacturing production technologies, enabled by digitalization, affect the optimum scale of

production and hence investment requirements and location decisions. Digitally enabled technologies such as 3D printing or continuous processing lead to production in small batches for the local market and thus influence investment decisions and location decisions of DMNCs.

Digitalization affects also the way DMNCs manage their internal operations and governance, manage their network of suppliers, govern their network of international supply chain and also engage their customers (Loonam et al. 2018). In particular, digital technology, through the ease of communications, allows DMNCs to centralize certain support functions and take advantage of specialization and economies of scale. DMNCs centralize functions such as HR, IT, analytics, pursing these functions either in their HQs or in "dedicated" affiliates that focus on these particular functions.

Also, technology and digital tools allow DMNCs to manage, coordinate and monitor more effectively their network of internal suppliers, streamlining efficiently their procurement and inventory control processes achieving efficiencies and economies of scale in operations (Rai et al. 2006). DMNCs employ technology and digitalization techniques to connect with their customers allowing them a more effective engagement in terms of better sensing and understanding their customers' taste and preferences and (through customer analytics), engaging them in a consistent manner with respect to their customers' shopping habits (through digital marketing techniques) and thus enhancing the shopping experience of their customers.

Consistent with the above, recent research by Chen and Kamal (2016) finds that the adoption of Information and Telecommunication Technologies (ICT) by MNCs facilitates communication among affiliates across different locations. This increases the likelihood of in-house production, as measured by increases in intra-firm trade shares. Furthermore, they find that more complex forms of ICT are associated with larger increases in intra-firm trade shares. Finally, their results indicate that MNCs in industries in which production specifications are more easily codified in an electronic format are less likely to engage in intra-firm trade, preferring outsourcing instead.

Also, Rangan and Sengul (2009) show that the adoption of ICT technologies by DMNCs exhibit a reduced propensity for transnational integration and internalization of activities. DMNCs thus seek opportunities outside of their direct control of ownership leading to more outsourcing.

### *2.2 DMNCs: Digitalization and Strategy*

Digitalization of operations has also important effects on the strategy and tactics DMNCs employ in managing their supply chain (Srai et al. 2016). In particular, DMNCs:

- Use digitization to monitor their sourcing and inventory control systems with automated control that helps them to manage proactively sourcing bottlenecks and avoid disruptions in their supply chain.
- Employ real-time factory scheduling and digital business process re-engineering that leads to greater productivity, improved delivery performance and higher responsiveness to change through sensor- and smart device-enabled management and joined-up enterprise resource planning, manufacturing execution and cloud systems.
- Pursue flexible factory automation by implementing technology, robotics and machine learning that facilitates factory automation through flexible reconfiguration. This process allows DMNCs to achieve economies of scale and lower unit costs despite higher product variety and greater customization.
- Digitize their production process that allows them to replace “subtractive” manufacturing processes (such as machining) with “additive” processes (such as laser sintering and digital printing) enabling them to develop new product designs and enhanced customization.
- Employ extending e-commerce techniques to web-based order management, including personalized configuration, omnichannel access and last-mile delivery. New business models are emerging that are based on customer-connected supply chains—constantly monitoring product usage and experience, and tailoring the offering. Sectors as diverse as construction vehicles (B2B) and consumer goods (B2C) are leading the way.
- Use predictive analytics and real-time risk management, enabled by sensors and track-and-trace processes to create visualization “watch towers”, optimize integration, predict disruptions and support dynamic decision-making.
- Use digital technology and with end-to-end transparency, real-time analytics and proactive resolution driven by customer connectivity manage to have control of product quality. Direct connections with customers, across internal operation networks, through suppliers, allow DMNCs to achieve faster problem resolution and prevention, and compliance verification.
- Employ product life cycle systems that provide accurate, up-to-date product information accessible throughout the value chain. This enables enhanced cross-organizational involvement in design, collaborative innovation, design for manufacture or procurement, and quicker time to market.
- Achieve a higher-level transformation that relates to the entire supply network. This involves digital network design, modelling and visualization tools based on drivers of costs, risks and resource access. It can lead to new network design principles and changes in supply collaboration, site location, capacity, inventory and customer response.

### *2.3 DMNCs: Connectivity and Servification*

At the same time, the servicification of manufacturing is a growing trend that impacts the value chain of manufacturing (Martin-Pena et al. 2018). The fragmentation of the value chain of manufacturing brings up various components of the value chain that are services which either become separate business entities or are outsourced to external providers. Digitization technologies allow for better communication between the DMNC and its outsourcers' network, and also enhanced day-to-day operations that support inventory-light control mechanisms, improved product design and specification, etc. Besides outsourcing ancillary activities, DMNCs employ revenue models that depend not so much on selling products but instead on selling services (e.g. maintenance and technical support) in relation to the products they sell. Digitalization technologies allow for better monitoring of the operation or fixed assets and sensors and wireless communications allow DMNCs to assess maintenance and servicing requirements of fixed assets they have sold to their clients (and of course charge accordingly).

Overall, the digitalization of the global supply chain has an impact on the local ecosystem of DMNCs especially in certain industries (Loonam et al. 2018). As the digitalization of the global supply chain leads DMNCs to adopt digitally enabled technologies in their operation, then they also "demand" from their local ecosystems of suppliers/clients to align themselves to adopt digitally enabled communication technologies and adjust accordingly to the digitalization of the global supply chains. Some industries, (e.g. automobiles or pharmaceuticals) are well advanced in such an adaption while other industries (agrifood) show a lower level of adoption.

## 3 Digitalization and the International Presence of DMNCs

Extensive research (Axarloglou and Pournarakis 2007 among others) study the effects of MNCs in the local markets that host them. As DMNCs adopt digital technologies and disrupt their models in engaging their market (Revenue Model) and their operations (Cost Model), they also disrupt the way they penetrate the world market. Specifically, a recent study (UNCTAD 2017) shows that revenue, employment and assets of DMNCs grow faster than the rest of MNCs. Also, assets of DMNCs grow faster than revenue and employment, showing a shift of value creation from labour to capital and consequently a shift in the composition of assets for DMNCs towards intangible assets (brand name, knowledge-related know-how, intellectual property, etc.) and cash.

### 3.1 DMNCs: Assets and Sales

Apparently the digitization of the business model of DMNCs influences their strategies and overall the flow of FDI (Eden 2016). By penetrating the global economy with lower amount of fixed and tangible assets and lower employment overall, they have a lower presence overseas and consequently lower impact in the local economy. Also, they have their HQs mainly in the developed countries (e.g. the United States). Given the change in their strategies, DMNCs penetrate the global market through online operations and online platforms (by engaging customers through them) so they just deliver products with local distribution channels. On the other hand, the digitalization of the global value chain (in terms of the development of fully digital products or the digitalization of the production of products/ services) allows DMNCs to achieve cost efficiencies not in terms of lower cost of resources but instead in terms of economies of scale (by amortizing the cost of producing digital content with more sales worldwide). These two developments reduce the market-seeking and efficiency-seeking motivation of DMNCs when expanding internationally, while the knowledge/expertise-seeking and also financial and tax-driven motivations are now important for DMNCs. These lead to differences in the scope of the presence of DMNCs in the local markets and of course on their impact in these markets.

The change in DMNCs' strategies leads to a much smaller share of foreign assets to total assets for DMNCs than the traditional MNCs and a higher share of foreign sales to total sales than foreign assets to total assets for the DMNCs (UNCTAD 2017). As the internet penetrates and influences the operation and sales modes of DMNCs, these companies increasingly manage to operate internationally with lower foreign assets to foreign sales and thus have overall a lower impact and footprint on the foreign market. Obviously, purely digital DMNCs (like platforms) operate entirely on the internet and thus the gap between the share of international assets and the share of international sales is the largest among all types of DMNCs.

For this group of companies, their presence in the foreign market is mainly through their business offices (that host support functions for the companies, e.g. HR, Finance, Marketing) and headquarters. DMNCs with mixed models (such as e-commerce and digital content providers) still show a light share of foreign assets to foreign sales compared to traditional MNCs. IT DMNCs (that provide either hardware like Samsung and Apple or software like Microsoft and Oracle) still have a light presence in local markets as their share of foreign assets is smaller than the share of foreign sales. Finally, DMNCs in Telecommunications are the exception of all these since they have a significant presence in the local markets (with comparable shares of foreign assets and foreign sales).

Recent studies (UNCTAD 2016) also show that for purely digital DMNCs (platforms) there is no correlation between the share of foreign assets and foreign sales as these platforms sell their services around the world with little presence in the local markets. On the other hand, there is such a correlation for multinationals that

offer digital content, and of course, this correlation becomes much stronger for Telecoms.

### *3.2 DMNCs: Profits*

At the same time, almost 62% of DMNCs' foreign profits are unremitted and this share has increased by 28% (between 2010 and 2015), while that same share has increased only by 8% for traditional MNCs (UNCTAD 2017). DMNCs maintain abroad most of their unremitted profits in terms of cash or cash equivalents, and since the total unremitted foreign earnings are almost six times the value of the foreign assets of the DMNCs, this indicates that DMNCs retain cash aboard not necessarily to finance the deployment of foreign assets but primarily for tax avoidance purposes or minimization of the tax burden through non-repatriation of the profits.

The geographic location of foreign affiliates also reveals the motives of these companies' international expansion. In particular, only 50% of all subsidiaries of DMNCs are foreign subsidiaries (while this share is 80% for traditional MNCs) and also, 40% of the subsidiaries of DMNCs are based in the United States while this share is only 20% for traditional MNCs. Overall, the data show (UNCTAD 2016) that there is a significant skewness of the location of foreign affiliates for DMNCs in favour of the United States and other developed countries, thus reverting the recent trend of outward FDI in favour of developing countries. This presents strong evidence supporting the premise that DMNCs are knowledge-driven and knowledge-seeking.

Overall, the impact of digitalization on the business model of DMNCs leads to the limited foreign asset footprint, large cash reserves (kept overseas), and overall a concentration of productive investment in developed countries, thus reversing traditional economic trends associated with MNCs for decades now (UNCTAD 2016). Of course, these new trends are more prevalent for companies that provide digital products/services or are enablers of digitalization, where their business models have been radically disrupted and transformed by digitalization, while these trends are not so prevalent in the case of MNCs with business models still resilient to the transformation of digitalization.

## 4 Digitalization, DMNCs and Investment Policy

The digital economy, in terms of infrastructure, digital content and digitalization of operations, depends on technologies that are deployed through investment and international investment (OECD 2015). Conversely, the digital economy transforms international production, and thus investment patterns. In other words, investment facilitates the development of the digital economy, and the digital economy itself evolves, and frequently also disrupts business models and international operations,

and in that way, dictates the patterns of international investment. Countries should facilitate the coevolution of the digital economy and the structure of investment flows in aligning investments with the evolution of the digital economy. Thus, a comprehensive investment policy framework for the digital economy should ensure not only that digital development is embedded in investment policies but also that investment policy is embedded in digital development strategies. Moreover, governments need to find a balanced approach that accommodates public concerns caused by digital transformation as well as the interests of private investors (UNCTAD 2017).

### *4.1 An Investment Policy Framework for the Digital Era*

The digitalization of economic activity and the rapid evolution of DMNCs show that (UNCTAD 2017):

1. DMNEs can reach overseas markets with a much lighter international asset footprint.
2. DMNEs generate less employment in host countries directly—their economic impact is largely indirect, through competitiveness benefits across all other sectors.
3. Digital adoption in all DMNEs is increasing the weight of intangibles and services in global value creation and placing new demands on host-country supply chain partners and technological infrastructure.
4. DMNCs have mostly knowledge-seeking and tax-avoidance motives in their international expansion, and in doing so, they run international operations based on technology with a lower amount of fixed assets in foreign markets, and thus, they usually have a lighter presence in and impact on these markets.

Certainly, most countries are actively encouraging the digitalization of their economy, as this offers significant development opportunities (OECD 2015). Digital development helps local firms access global markets or integrate into global e-value chains. The digital economy also yields new opportunities for local enterprise development, through international investment or links with global digital firms, in across-borders digital sectors (e-commerce and digital media), social sectors (e-health, e-education), in new niche industries (e.g. the creation of a digital creative or app-development industry).

Given the significant changes in the structure and the impact of FDI flows in the digital economy and the importance of these flows, especially for the evolution of the digital economy in developing countries, governments need to develop policy frameworks to streamline local investment and FDI investments to support the evolution of the local digital economy. In the digital economy, FDI flows do not seek anymore low-cost opportunities, but instead, they are looking for digital infrastructure and connectivity, high digital adoption and knowledge-intensive local talent.

The policy actions to realize the opportunities and deal with the challenges cut across many areas (UNCTAD 2017). Core investment policies related to the establishment, protection, facilitation and promotion of international investment are important, especially where foreign investment is crucial for rapid digital development and where investment costs in physical assets are high, such as for the development of digital infrastructure. Public–private partnerships, including those with foreign investors, are also an important tool for infrastructure development. For the development of the digital sector, other investment-related policy areas tend to be more important (e.g. taxation, trade, technology, skill-building).

In developing the investment policy framework to support investment flows in the digital economy, policymakers need to assess how new modes of investment and changing investment impacts affect the structure and the operations of the market and the necessary market or industry regulations to be implemented. For instance, some analogue-era regulations may become obsolete (such as retail restrictions that are bypassed by e-commerce) or risk slowing down digital adoption (such as sector regulations that effectively block new digital entrants); others may need adaptation to the digital age to achieve their public policy objectives. At the international level, policymakers need to assess the implications of the digital economy on investment treaty-making, and the investment dimension of evolving rules in e-commerce and services trade.

## *4.2 Investment Policies and Digital Divide*

In developing their investment policies, countries need to manage the significant "digital divide", observed especially in developing countries, in terms of the adoption of digital technologies by companies and individuals (Chen and Wellman 2004). In particular, the share of people that use digital technologies in developing countries is less than half of the respective one in developed countries, while the adoption of broadband and usage of key digital tools, such as email and websites, among companies is also lagging in developing countries. Although the digital divide is smaller for companies than for individuals, it is quite alarming, given the competitiveness benefits companies can gain from the adoption of digital technologies (UNCTAD 2017).

As A. Guterres, U.N Secretary-General states "we must work to close the digital divide, where more than half the world has limited or no access to the Internet. Inclusivity is essential to building a digital economy that delivers for all. New technologies, especially artificial intelligence, will inevitably lead to a major shift in the labour market, including the disappearance of jobs in some sectors and the creation of opportunities in others, on a massive scale" (UNCTAD 2019, p. 6). To close the digital divide, policymakers take initiatives in developing the country's broadband infrastructure, promoting digital firms, both international and local (the "digital sector"), strengthening e-government, and encouraging businesses and

SMEs to adopt digital technologies, as well as promoting general digital skills and competencies.

Policymakers should also consider that digital development requires the development of adequate digital infrastructure to provide the necessary connectivity (OECD 2015). They also need to design policies to support the actual uptake of available connectivity, such as competition policy frameworks to improve the affordability of devices and services. Moreover, they need to undertake other measures to improve inclusive internet access, through education, skill-building, R&D and other policies to facilitate digital adoption among local firms, especially micro-, small- and medium-sized enterprises, where the adoption of digital technologies can significantly boost productivity.

> With coverage well ahead of adoption in many developing countries, speeding up digital development requires a focus on investment in local digital content and services to increase demand. This should include stimulating investment in local enterprise development by creating and maintaining a conducive regulatory framework for digital firms and by undertaking active support measures, which may include establishing technology or innovation hubs and incubators, building or improving e-government services, supporting innovative financing approaches and instituting skill-building programmes. Linkages with global firms can help, and the involvement of foreign investors in local digital firms can accelerate their growth, but developing the digital sector mostly means supporting developing domestic enterprise rather than promoting investment by digital MNEs. (World Investment Report 2017)

Of course, as countries progress in digital development, government priorities shift from supporting infrastructure to promoting the development of content and services by digital firms, as well as digitalizing the rest of the economy. To adapt to evolving needs and technology, digital development strategies must be flexible and reviewed regularly. There is, of course, no single digital development blueprint; each country needs to develop along the three dimensions, setting out its own path.

However, and especially for developing countries, a recent UNCTAD study (World Investment Report 2017) shows that only a small portion of the digitalization initiatives (either in terms of digital infrastructure or in terms of digitalization of the economy) focus on the necessary investment (and the financing of it) to support this digitalization. Given that in these countries a significant part of the investment is drawn through FDI inflows, DMNCs can play an important role in investing in developing countries supporting the digitalization of these economies. DMNCs (and in particular telecoms) certainly play an already important role in financing digital infrastructure in developing countries and in various industries such as healthcare, education, financial technology, etc. (see Accenture 2016, 2017; Deloitte 2016).

In conclusion, in most countries, investment policymakers have been less active in the formulation of digital development strategies. However, as the digital economy rapidly evolves, frequently in a disruptive way, policymakers need to take a much more active role and frequently in a more proactive way. They should embed digital development in investment policies, as the digitalization of the economy penetrates all industries and the society.

## 5 Conclusions

The rapid adoption of digital technologies in their operations by DMNCs disrupts their business model and the way they engage their markets, manage their operations, and design and implement their internationalization strategies. DMNCs now serve the world economy with a much lower volume of fixed assets and a weaker direct presence in and impact on the local markets. They also pursue location decisions with knowledge/expertise-seeking and also financial and tax-driven motivations. Finally, these trends are very important for countries when they design their investment policies in facilitating investments to support the evolution of the digital economy.

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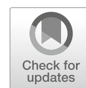
# Part II
# EU Policies for Growth

# EU Corporate Governance Framework: The Role of the EU Institutions




**Vasileios Koniaris**

**Abstract** The aim of this chapter is to present the stages of development of corporate governance of the European Commission by referring to Small- and Medium-sized Enterprises (SMEs) and their role in the Industrial Policy of the EU. The latter refers to measures aimed at stimulating growth and competitiveness in the EU economy as a whole with the priorities of fostering competitiveness, encouraging innovation by supporting actions related to innovation and research, promoting businesses that produce in a sustainable and socially responsible way, working to ensure that enterprise and industry have access to resources, including finance, skilled labour, energy and raw materials, promoting a business-friendly environment, supporting the internationalization of EU enterprise and industrial goods and services and providing support for the protection of intellectual property rights.

## 1 Introduction

The European Commission (2003) defines SMEs as those enterprises, which irrespective of their legal form, employ fewer than 250 persons and have an annual turnover not exceeding 50 million euros and/or an annual balance sheet total that does not exceed 43 million euros. It is argued in this presentation that the creation of a legislative threshold is incapable of defining the condition of an enterprise in a dynamic socio-economic environment.

Industrial policy in the EU for SMEs does not have a long tradition. It was in 2005 when, for the first time, the Commission (2005) undertook initiatives for the proposal of a work programme of cross-sectoral and sectoral policy initiatives. In this work programme, the fact that in the manufacturing industry over 99% of companies were SMEs employing 58% of the total workforce was presented. At

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that point, corporate governance of SMEs was not a topic on the agenda. Issues such as financing, intellectual property rights and skill gaps in the sectors were priorities set by the EU.

Bruno and Claessens (2010) highlighted the fact that under the mid-term review of industrial policy, it was acknowledged that "*at the same time (the SMEs) are less well equipped to cope with regulation and administrative burdens- often entailing costs that are not directly related to the size of the enterprise*" (European Commission 2007). Emphasis on this stage was given to innovation, especially the linkage between SMEs and the research community, based on the Clusters Initiative for the promotion of the European Knowledge Area (European Commission 2015). The previous statement created the notion that SMEs should not be forced to bear any administrative or legal demands that could create barriers to their operation. This was of great importance for corporate governance codes that would increase their costs of operating.

## 2 Corporate Governance

Although there have been numerous approaches on the definition of Corporate Governance, the European Central Bank (2004) describes corporate governance as procedures and processes according to which an organization is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization—such as the board, managers, shareholders and other stakeholders—and lays down the rules and procedures for decision-making. Although all approaches combined are described in the definition provided by the ECB, there are significant differences concerning particular issues such as shareholder rights, board composition, executive bonuses and others based on the national legal and cultural framework where these corporate governance definitions are created (Bebchuck et al. 2009; Weston et al. 2013).

For the advocates of corporate governance, proper governance of a company protects the interests of investors and shareholders. La Porta et al. (1997) have examined key legal rules in 49 countries in order to aggregate them into shareholder (antidirector) and creditor rights' indexes considering enforcement mechanisms such as the efficiency of the judicial system and measures of the quality accounting standards. Furthermore, legal scholars such as David and Brierle (1985) have insisted, always focusing on shareholders' rights, on enforcing legal systems in order to put pressure on companies to adopt corporate governance measures.

On the contrary, it is argued that too much emphasis put on proper corporate governance structures will have negative results in the functioning of the enterprise. This argument, as put forward by Durden and Pech (2006), describes corporate governance as an expensive procedure, both in time and money, especially when the business environment calls for high decision speeds and flexibility. These arguments although originating from the United States, especially after the Sarbanes–Oxley Act of 2002, describe a situation where corporate governance is an expensive procedure,

especially for companies that operate on low-profit margins. Although the same arguments do not apply for the EU, especially because of the voluntarist compliance for not-listed companies, it could be said that proper corporate governance structures would increase the operational costs especially for SMEs (Du Plessis et al. 2005).

# 3 The Stages of Development in the Approach of the Commission

## *3.1 The Infant Stage, the EU Corporate Governance Framework Before 2009*

Before 2009, corporate governance in the EU remained to what can be described as the infant stage of its development. Although national initiatives had already been applied, especially for large companies, SMEs were left outside of this framework based on the wider "comply or explain" principle. Concerning listed companies under the Shareholder Rights Directive in 2007, different issues were regulated such as proxy voting, participation and voting in general meetings, the agenda of the meetings and others.

Yet, as already mentioned, the initiatives of the EU focused on lessening the operational costs of SMEs in order to promote their financial sustainability. In that aspect, corporate governance measures were not a priority to be undertaken.

## *3.2 The Adolescent Stage, the Impact of the Financial Crisis of 2008*

It was acknowledged in 2010 that efforts put forth by the EU did not have the proper results in the development of SMEs. Especially concerning innovation, it is mentioned that "*too few of our innovative SMEs grow into large companies. Although the EU market is the largest in the world, it remains fragmented and insufficiently innovation friendly*" (European Commission 2010a). In 2011, questioning the necessity for unlisted companies to implement corporate governance codes, the Green Paper of The European Governance (2011) allowed Member States to permit SMEs that are listed companies not to set up separate audit committees. Promoting the creation, growth and internationalization of SMEs thus has to be "at the core of the new EU integrated industrial policy" (European Commission 2010b).

The Commission wishes to continue to explore alternative means improving the administrative and regulatory framework for SMEs acting cross-border (European Commission 2012b). It will try to provide them with simple, flexible and unified rules across the EU to reduce the costs SMEs are currently facing. Still, the focus on corporate governance was only placed on companies that are listed in the national

stock markets and although the issue of absent stakeholders is specifically mentioned for companies and financial institutions, the same issue is not mentioned for SMEs.

The aforementioned approach can be reflected as a burden in the credit demands from SMEs to financial institutions. In accordance with the European Commission, less than one-third of the Dutch and Greek SMEs and only around half of the Spanish and Italian SMEs got the full amount of credit they applied for in 2013 (European Commission 2014a). This big gap in corporate governance provisions between SMEs and financial institutions or big companies can create opportunity costs concerning the lending of SMEs for their economic and operational expansion.

On the contrary, concerns have been raised regarding fiscal evasion, workers' rights and sustainable corporate governance in general especially by the European Parliament (2018). The above concerns are connected with shell companies (or letterbox companies), meaning companies that are either directed by a hidden Ultimate Beneficial Owner (UBO) or that are registered in another Member State different than the MS of their main economic activities for tax reasons. The common characteristic of these companies is that there is an absence of real economic activity in the Member State of registration.

At that point, in 2014, a new approach on the importance of corporate governance was put forth for the financial sector, under the fighting against short-termism which damages European Companies and the economy. It is argued from the European Commission (2014b) that shareholders must be encouraged to "*engage more with the companies they invest in, and to take a longer term perspective of their investment. To do that, they need to have the rights to exercise proper control over management, including with a binding 'say or pay'. (I) also see it as a priority that company law offers European SMEs an efficient framework for their operations and growth. The European Single Member Company will help entrepreneurs reduce costs and organise their activities abroad*".

What we can understand from the aforementioned statement is a shift from national policies concerning corporate governance of SMEs towards an effort for the creation of a European framework for SMEs that operates on a European level. The second initiative is to secure SMEs funding via instruments such as HORIZON 2020 and the European Innovation Council pilot. Moreover, the European Commission (2014c) sets ambitious plans such as crowd-funding for SMEs and focuses on those SMEs that do not manage to access bank finance, venture capital or reach the stage of IPO without examining the reasons behind this incapacity.

Concerning the Single-Member Company Directive (2009), it, in the framework of flexibility, failed to address the main challenge that SMEs face, meaning access to finance in order to reach the stage of IPO. This eventuality was apparent even in 2012 when the European Commission (2012a) was set to further explore and collect data on the SPE in order to enhance cross-border opportunities for SMEs. Different solutions, such as secondary markets for corporate bonds, revitalization of securitization markers with covered bonds and private financing, were also proposed by the European Commission (2014a) but their implementation faces serious challenges in the current economic reality of the EU.

## 4 Conclusions: The Quest for the Proper Motivators for the Development of SMEs

Corporate governance in the EU concerning SMEs remains in the adolescent stage, especially when compared to the significance of corporate governance as a motivator for growth for the SMEs. It is argued that SMEs in the EU seem to prefer to stay in this stage as they are the receivers of a variety of benefits from either the EU or the state in which they operate. At the same time, they lack other motivators in order to promote transparency of their activities as well as to establish proper corporate governance structures that will lead to gaining better access to the financial markets.

SMEs have specific growth stages that need to be achieved for the company to be sustainable. From existence to take-off, the issue of financing the SME's growth is crucial. Nevertheless, the focus of any national or transnational regulatory mechanism should not be to focus exclusively on the environment of the SME rather than on the structure of the SME itself.

One major proposal could be the shift from the mentality of "comply or explain" towards a more decisive set of measures from the EU. SMEs, described as the backbone of the economic development of the EU, will need stricter measures of compliance when it comes to their corporate governance structures. This could be implemented through a revised definition of SMEs as put forward by the European Commission. Still, it is agreed that these measures should not act as a burden to the balance between flexibility and cost. It is mentioned that one of the reasons that have led to the underdevelopment of the ambitious Societas Europe Directive was the fragmented corporate governance cultures that existed throughout Europe. The creation of the European Company was an effort by the Commission to offer a unified framework of operation for companies in the EU.

Corporate governance in SMEs does not concentrate solely on the protection of the shareholders of the company; it is taking into account all possible relations that SMEs can create in the European or international environment. Still, a major obstacle towards this direction is that financial institutions in the EU do not put much emphasis on the qualitative criteria of SMEs when the latter apply for financing. Major banks will assess financial data, such as financial statements, cash flows and the long-term financial planning, growth of the proposed business plans and investments. In any proposed business plan, corporate governance remains of low importance when it is evaluated for financing. This is further intensified after the liquidity issues that the financial institutions face currently in the EU. From the side of the bankers, besides the major problem of liquidity, another reason for this phenomenon is the lack of transparency that exists in many SMEs. In many cases, their organizational features and business strategies are not publicly disclosed. This leads to another argument from the EU, that many SMEs are used for money laundering or terrorist funding (European Commission 2013).

It is important for SMEs to adopt and comply with corporate governance measures since this will increase their possibility to better access funding. Another advantage of this is that corporate governance is a prerequisite for the development

stage of SMEs when they wish to get listed into stock markets. Last, it remains to be seen what the implications of the proposed Transatlantic Trade and Investment Partnership (TTIP) concerning European SMEs will be.

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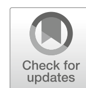
# The EU Digital Single Market and the Platform Economy



**Despoina Anagnostopoulou**

**Abstract** Since 2010, the EU policy concerning the Digital Agenda and the Digital Single Market Strategy aimed to advance EU growth with concrete actions, in order to "unleash the potential of e-commerce". Among the major achievements of the Digital Single Market Strategy is the Regulation on Online Intermediaries, i.e. Platform Operators (e.g. Amazon, eBay, Booking.com, Google Shopping) to be applied in July 2020. The chapter explains the forms and the contribution of the platform economy to EU growth. It then focuses on Regulation (EU) 2019/1150 on promoting fairness and transparency for business users of online intermediation services, regulating the contract between the business user (supplier, usually an SME) and the online intermediary, in order to ensure fair terms and to prevent unfair practices. The contribution analyses the main rules of the contract, explains the method of business users' ranking and the effectiveness of the redress system, including mediation, between the platform operator and the business user. Since the case for the benefits of the platform economy is still controversial, the contribution assesses whether the EU's attempt to control the immense power of the colossal platform operators, most of them outside the EU, has struck the right balance between growth through new business models and fair competition.

## 1 Introduction: The Digital Agenda and Its Impact on EU Growth

In March 2010, the European Commission under its President M. Barroso (2009–2014) announced the "Europe 2020 Strategy", aimed at reviving the European economy. It targeted at "smart, sustainable, inclusive growth" with greater coordination of national and European policies (European Commission 2010a).

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The Europe 2020 Strategy included the flagship initiative "Digital Agenda", which aimed to "speed up the roll-out of high-speed internet and reap the benefits of a *Digital Single Market* (hereinafter DSM) for households and firms" (European Commission 2010b, p. 6). For example, one of the Digital Agenda's objectives was to achieve the Universal Broadband Coverage with speeds of at least 30 Mbps and Broadband Coverage of 50% of households with speeds of at least 100 Mbps by 2020. In addition, it aimed to "create a true single market for online content and services, i.e. borderless and safe EU web services and digital content markets, with high levels of trust and confidence" (European Commission 2010b, p. 14).

The Digital Single Market was the first of the seven pillars of the Digital Agenda with 20 planned actions (Anagnostopoulou 2013a, pp. 119–123). It was considered by the European Commission as a policy that would "generate new types of growth", with benefits for all territories and economic sectors of the EU, and lead to further integration of the internal market. The EU could not afford the cost of a fragmented digital market anymore and should double online sales and the share of the "*internet economy*" in the EU's GDP by 2015 (European Commission 2011a, p. 1).

The EU had already adopted important Directives to boost e-commerce, e.g. to information society services (1994), e-commerce (2000), e-signature (1999), but realized that these specific efforts were not adequate (Anagnostopoulou 2013b).

In addition, the DSM would benefit consumers, SMEs, workers, citizens and the environment. The first main obstacles to the DSM that were identified by the European Commission were: the legal fragmentation between member states; the inadequate information for online service operators or protection for internet users; the inadequate payment and delivery systems; dispute settlement problems; and the insufficient use of high-speed communication networks (European Commission 2011a, b, p. 4).

Despite its achievements in other areas of the Digital Agenda (Anagnostopoulou 2013a, pp. 121–127), the pro-growth Commission's 2011 proposal (European Commission 2011b) to remove legislative barriers and reduce the legal cost of e-commerce, by introducing an optional Common European Sales Law (CESL) was not approved by the European Parliament and the Council and was eventually withdrawn (Anagnostopoulou 2013b).

## 2 The Digital Single Market Strategy (2015)

The European Commission, under its President J.C. Juncker (2014–2019) established the completion of the DSM as the second of its 10 political priorities. It was claimed that a connected DSM could "create opportunities for new start-ups and allow existing companies to grow and profit from the scale of a market of over 500 million people" and that it would "generate up to EUR 250 billion of additional growth" in the EU until 2019, "thereby creating hundreds of thousands of new jobs" (European Commission 2015, pp. 2–3). In addition, the Commission argued that until 2025, most economic activity would "depend on 'digital ecosystems',

integrating digital infrastructure, hardware and software, applications and data", a development that the EU had to take into account for its competitiveness policy (European Commission 2015, p. 13).

The new DSM Strategy was adopted in May 2015, and has gradually been built on three pillars: better access for consumers and businesses to digital goods and services across Europe; creation of the right conditions and a level playing field for digital networks and innovative services to flourish; and maximization of the growth potential of the digital economy (European Commission 2015, pp. 3–4).

In its strategy, the European Commission described the EU DSM as the area "in which the free movement of persons, services and capital is ensured and where the individuals and businesses *can seamlessly access and engage in online activities* under conditions of fair competition, and a high level of consumer and personal data protection, irrespective of their nationality or place of residence" (European Commission 2015, p. 3). Thus, the concept was based on the definition of the Internal Market (art. 26 para. 2 TFEU), extended with the non-discriminatory seamless access and engagement in online activities.

In 2016, both the European Council and the European Parliament supported the DSM Strategy, which they considered significant for an inclusive EU growth (European Commission 2017, p. 2). Along with the Capital Markets Union and the Energy Union, the DSM Strategy was considered very important for economic and social development (European Council 2016, p. 5). Based on this support, the Juncker Commission managed to obtain approval by the EU co-legislators (Parliament and Council) for 28 out of its 30 proposals. These measures relate to six sectors: *Connectivity* (e.g. 700 MHz, Wifi4EU); *e-Commerce* (consumer protection cooperation, VAT e-commerce, cross-border parcel delivery, VAT e-books, platform-to-business); *Data* (creating a competitive data economy within the DSM); *Media/copyright* (e.g. audiovisual media services directive); *Trust* (e.g. data protection rules, cybersecurity and e-payments); and *e-Gov*: e.g. the Single Digital Gateway (European Commission 2019a).

Quite important was the Communication on Building a European Data Economy, which was adopted in January 2017 and addressed issues concerning big data, cloud services and the Internet of Things (European Commission 2017, p. 32). The measures that the EU has adopted include legislation that forms the eco-environment of platforms such as the Directives 2019/770 and 2019/771 on certain aspects of contracts for the sale of goods and the sale of digital content (Anagnostopoulou 2018a), the Regulation 2018/302 on the prohibition of geo-blocking, the Regulation 2016/679 on the processing and free movement of personal data, the Directive 2019/2161 on the better enforcement and modernisation of Union consumer protection and the Regulation 2019/1150 on online intermediaries (platform operators), for example Amazon, Booking.com, Google.

These measures will be implemented and monitored by the new von der Leyen Commission (2019–2024). The new President of the European Commission has proposed to create "A Europe fit for the Digital Age", to increase investment on Artificial Intelligence, and to advance the Internet of Things and Blockchain Technology, as well as to adopt "a new Digital Services Act to upgrade EU liability and

safety rules for digital platforms, services and products, and complete the [EU] Digital Single Market" (von der Leyen 2019, p. 13).

## 3 The Platform Economy and Its Impact on Growth

The online platforms "revolutionised the digital economy and the access to information and content in an increasingly cross-border context" (European Commission 2017, p. 21). A significant part is the "expansion of the economy based on digital platforms that match demand and supply without an intermediation of traditional corporations" changing, however, workers' habits and rights (Grajewski 2018, p. 1). In the EU, the recent data demonstrate that 60% of private consumption and 30% of public consumption of goods and services related to the digital economy take place through platform intermediaries with more than one million business users (Madiega 2019, p. 3; European Commission 2018, pp. 10, 20–21).

The platform economy is a new business model, presenting a paradigm shift for businesses which do not seem to fit in the existing regulations. It is considered a non-conventional and dynamic system that includes the ecology of continuously evolving business models (Lobel 2016, pp. 5, 11).

Platforms are the innovators in the digital economy, as they generate, accumulate and control an enormous amount of data about their customers and use algorithms to turn data into usable information (European Commission 2015, p. 11). They are "key enablers of entrepreneurship and new business models", helping SMEs to reach consumers, offering access to new markets and increasing the consumer choice of goods based on online competitive pricing by search engines (Regulation 2019/1150, preamble, para. 1–3).

Online intermediaries stimulate employment and entrepreneurship by lowering barriers to starting and operating small businesses (OECD 2011, p. 12). They assist smaller companies achieve "big company" benefits from digitalization and adopt the new Internet technologies and business models at a fraction of the cost that they would incur without them (Thelle et al. 2015, p. 3).

Online intermediaries also support consumers and facilitate their empowerment and choice, as well as their improved purchasing power through downward pressure on prices (OECD 2011, p. 12). Platforms are also used for the *sharing economy* (peer-to-peer or collaborative economy) which improves consumer choice, but also potentially raises new regulatory questions (European Commission 2015, p. 11; Hatzopoulos 2018, p. 41; Busch 2019). Within the sharing economy model, all individuals can become semi-entrepreneurs and all resources may be used (Lobel 2016, pp. 4–5).

To date, online platforms help more than one million businesses to reach customers across the EU (European Commission 2019b). The European Commission claims that 82% of SME respondents in a 2016 Eurobarometer interview of 4904 companies in 10 member states, relied on search engines to sell products and/or services online, with 66% indicating that their position in the search results has a

significant impact on their sales (TNS 2016). In another B2B survey, 90% of the respondents use online social media platforms for business purposes, with 72% of the respondents using the same firm, while 56% of the respondents "considered the platforms they use to reach customers as 'important' or 'very important' to their business" (TNS 2016; European Commission 2017, p. 22).

The United States was the first to nourish platforms. In conformity with its "hands-off approach", the United States has not regulated the platform economy (Anagnostopoulou 2017). In general, there is a "safe harbour" approach, which provides certain online intermediaries with conditional immunity to online copyright infringements: third-party initiation based on an automatic technical process (without the service provider's knowledge or control) and no service providers' content modification in the course of delivering the service. Despite the fact that intermediaries do not have a general monitoring and surveillance obligation, they may be asked to identify users, preserve traffic data or take down content (US Communications Act, Section 230; Digital Millennium Copyright Act; US Technology Agenda as cited in Anagnostopoulou 2017; Lobel 2016, p. 40).

The EU has endorsed the "safe harbour" approach (Directive 2000/31/EC, art. 12–14, European Commission 2012, pp. 12, 24–30; CJEU Joined cases C-236/08 to C-238/08, *Google* vs. *Louis Vuitton Malletier SA,* para. 110; Anagnostopoulou 2017).

However, some types of platforms can control access to online markets and can exercise significant influence over the remuneration of various players (European Commission 2015, p. 11), abusing their market power.

Therefore, some EU member states adopted national laws that aim to regulate platforms, especially those of the sharing/collaborative economy, for example in France, Italy, Germany and Greece (Wiewiórowska-Domagalska 2017, pp. 1–2; Anagnostopoulou and Stavridou 2018, p. 427–430; Valque 2018, pp. 83–84).

Following the mid-term review of the DSM Strategy, the European Commission identified the promotion of fairness and responsibility of online platforms as an area where further action was needed to ensure a fair, open and secure digital environment (European Commission 2017). In May 2018, the Commission adopted the proposal for a Regulation on the promotion of fairness and transparency for business users of online intermediation services (European Commission 2018). In June 2019 the Regulation (EU) 2019/1150 was adopted.

## 4 The Regulation (EU) 2019/1150 on Promoting Fairness and Transparency for Business Users of Online Intermediation Services

The Regulation (EU) 2019/1150 (hereafter 'the Regulation') is "the first regulatory attempt in the world to establish a fair, trusted and innovation-driven ecosystem in the online platform economy" (Madiega 2019, p. 1).

In fact, the Regulation advances EU rules from a "transaction-oriented" approach to a "platform organisation-oriented" stage, thus confronting the challenge of electronic platforms as the dominant organizational model (Rodríguez de las Heras Ballell 2017, p. 146). The choice of the legislative instrument (Regulation instead of Directive) demonstrates that the EU aims at directly applicable uniform rules. The Regulation deals, for the first time, with problems of the "triangle economy" instead of the regular "chain economy" where the final supplier is liable to the consumer (Wiewiórowska-Domagalska 2017, p. 4).

The Regulation comprises the mandatory rules regulating the contract P2B, i.e. between the platform intermediary/operator and the business user (supplier, usually an SME), in order to ensure fair terms and prevent unfair practices by the most powerful contracting party, the platform. The Regulation applies to "online intermediation services" and "online search engines", regardless of whether they (the online intermediaries/platform operators) have their place of establishment or residence in a member state or outside the EU, and irrespective of the applicable law. The online services should be provided or offered to be provided *to business users and corporate website users:* (1) having their place of establishment or residence in the EU, and (2) offering goods or services to consumers located in the EU (Regulation 2019/1150, Article 1, Paragraph 2; compare Regulation 2016/679, Article 3, Paragraph 2).

The Regulation harmonizes transparency rules applicable to contractual terms and conditions, ranking of goods and services and access to data, and establishes redress mechanisms. It also imposes the description of the type of any ancillary goods and services offered to consumers through online intermediation services and the description of whether and under which conditions the business user is allowed to make that offer (Regulation 2019/1150, Article 6). In this contribution, it is not possible to analyze all of its rules and therefore the analysis is limited to certain specific issues.

## 5 Specific Issues of the Regulation (EU) 2019/1150

### *5.1 Field of Application and Uniform Definitions*

Providers of online intermediation services (e.g. Amazon and eBay) and online search engines (e.g. Google Search) will implement the Regulation in their contractual relations with online business users established in the EU (e.g. online retailers, hotels and restaurants, app stores), which use such online platforms to sell and provide their goods and services to customers in the EU. The Regulation will apply to all e-commerce market places and search engines regardless of their establishment in a member state or a third state (Madiega 2019, p. 4).

According to Article 2, Paragraph 2 of the Regulation, the term "Online intermediation services" means services that:

(i) Constitute "information society services", i.e. any service normally provided, for remuneration, at a distance, by electronic means and at the individual request of a recipient of services (Directive 2000/31/EC, Article 2(a); former Directive 98/34/EC; Regulation 2015/1535, Article 1(b)); and
(ii) Allow business users to offer goods or services to consumers in order to facilitate direct transactions between them, even if the transactions are not ultimately concluded; and
(iii) Are provided on the basis of contractual relationships between the provider of intermediary services and business users which offer goods or services to consumers.

This definition excludes "peer-to-peer" online intermediation services without the presence of business users and pure "business-to-business" online intermediation services which are not offered to consumers. In addition, it does not apply to platforms such as Uber, since its intermediation service "must be considered to be inseparably linked with a transport service" and the service provider exercises "decisive influence on the conditions under which such services are provided" (Court of Justice, C-390/18, *Airbnb Ireland,* Opinion (Szpunar), Paragraphs 48–53 and Court of Justice, C-434/15, *Asociación Profesional Elite Taxi*).

The Regulation applies only between P2B (Platform to Business user or corporate website user). Both business users and corporate website users are private individuals or legal persons who/which offer goods or services to *consumers* for purposes relating to its trade, business, craft or profession. The difference is that the "business user" acts in a commercial or professional capacity through online intermediation services (Article 2 (1)), while the "corporate website user" uses an online interface with applications, including mobile applications (Article 2 (7)).

The Regulation applies also to "online search engines"; that term refers to a "digital service which allows users to perform searches" of websites on the basis of a query (keyword, voice request, phrase or other input) and returns results (Article 2 (5)). This includes, in particular, "online e-commerce market places" on which business users are active (e.g. Amazon Marketplace, eBay, Skyscanner).

The above mentioned term "online market place" is broader. According to Article 3 (n) of the Directive 2019/2161, "online marketplace" means "a service using software, including a website, part of a website or an application, operated by or on behalf of a trader, which *allows consumers* to conclude distance contracts *with other traders or consumers"*. However, Consumer to Consumer (C2C) relationships are not included in the field of application of the Regulation 2019/1150. This is the reason why the Regulation sets out the above mentioned condition that business users should be active in the online market place.

The Regulation does not apply to online payment services (e.g. compare 2018 US Supreme Court, *Ohio v. American Express*; Chiapetta et al. 2018; Farell and Greig 2016). It does not apply to "online advertising tools" and "online advertising exchanges" which are "not provided with the aim of facilitating the initiation of direct transactions and which do not involve a contractual relationship with consumers" (Regulation 2019/1150, Article 1, Paragraph 3).

It is obvious that the Regulation does not cover all types and definitions of platforms. For example, the European Law Institute, under the term “platform” expressly includes advertisements placed by suppliers within a digital environment controlled by the platform operator, which can be browsed by customers, in order to contact suppliers and to conclude a contract outside the platform; offer comparisons, or other advisory services to customers . . . and direct them to suppliers’ websites or provide contact details (European Law Institute 2019). The Regulation applies only to certain platforms and only P2B.

## *5.2 Transparency and Fairness of Contract Terms (Articles 3 and 8)*

According to the aforementioned 2016 Eurobarometer survey (TNS 2016), 20% of business user respondents considered online platform’s contractual terms and conditions and related practices to be unfair and characterized them “as being generally complex and vague”. The reasons include “a lack of transparency on platforms’ practices concerning data and content”; sudden changes in contractual terms or prices which business users are unable to negotiate and de-listing; and “online platforms’ practice of unilaterally changing them, often without notice” (TNS 2016; European Commission 2017, pp. 24–25).

To remedy the unfair situation against the business users, the Regulation imposes the following obligations to the providers of online intermediation services: to draft their terms and conditions in a plain and intelligible language; to keep them easily available to business users including in the pre-contractual stage (Article 3, Paragraph 1 (a) and (b)); and to notify business users of any planned modifications. These modifications should not be implemented before the expiry of a reasonable notice period (in principle, 15 days) and cannot have any retroactive effect.

The terms and conditions will not be legally binding for business users if these conditions are not observed. Non-compliant terms and conditions will be null and void, i.e. with effect *erga omnes* and *ex tunc* (Regulation 2019/1150, Article 3 Paragraph 3; Madiega 2019, p. 4).

Providers of online intermediation services have the obligation to justify their decision without undue delay in case of a restriction, suspension or termination of services for a business user. They must provide a statement of reasons for terminating (with a notice period of at least 30 days) and restricting or suspending services to business users (Regulation 2019/1150, Article 4).

Providers of online intermediation services and online search engines must also provide a description of any differentiated treatment in relation to goods or services. The above mentioned obligations create a level playing field where the rules of the game are clear.

## 5.3 *Ranking Issues*

Ranking has a significant impact on SMEs' sales on the platform, which claim that there is a lack of clarity as to the conditions for access and use of ranking data by business users (Madiega 2019, p. 2). In addition, there are complaints about the lack of transparency and verifiability in the way platforms actually use algorithms for de-ranking or otherwise penalizing businesses for matters unrelated to their performance in the criteria usually incorporated in the algorithms (European Commission 2017, p. 26). There is also the fear that a platform may favour its own competing products or services, e.g. through more favourable ranking; or favour the exclusive use of superior data access to outperform third-party business users; or discriminate between different third-party suppliers and sellers, e.g. on their search facilities (European Commission 2017, p. 27; Madiega 2019, p. 2).

Therefore, the Regulation provides that online intermediaries and search engines must set out in their terms and conditions "the main parameters, which individually or collectively are most significant in determining ranking and the reasons for their relative importance" and provide an easily understood, public and updated description, as well as mention the possible ways to influence ranking. They are not required to disclose neither algorithms nor their trade secrets, since their commercial interests are protected by the Directive (EU) 2016/943 on trade secrets. Such an obligation would impede their ability to act against bad-faith manipulation of ranking by third parties (Article 5).

"Ranking" means the "relative prominence given to the goods or services offered through online intermediation services or the relevance given to search results by online search engines, as presented, organized or communicated" by them, "irrespective of the technological means used" (Regulation 2019/1150, Article 2 (10)). Business users should also be informed as to how online platforms can influence their ranking position, for example, through the payment of additional commissions. In this context, the Regulation prevents providers of online intermediation services to abuse their power by manipulating such an important aspect, as ranking.

## 5.4 *Most Favoured Customer Clauses or Restrictions to Offer Different Conditions Through Other Means*

Providers of online intermediation services are required to explain on what grounds they restrict the ability of business users to use other alternative services to offer the same goods and services to consumers under different (more favourable) conditions (Regulation 2019/1150, Article 10).

The Regulation considers as of legitimate purpose the Most Favoured Customer (MFC) clauses or the "no other distributor will receive a better deal" if they are compliant with applicable EU competition rules (Madiega 2019, p. 7).

Most-favoured-customer clauses are contractual terms agreed among firms which usually stipulate that a seller will offer its goods or services to the counterparty on terms that are as good as the best terms offered to third parties, confirmed with price comparison tools and are increasingly scrutinized by competition authorities in many countries because of their potentially anti-competitive effects and their possibly unlawful nature. France, Austria, Italy and Belgium have introduced legislation to prohibit some of these practices (Strowel and Vergote 2016, p. 10). The Regulation restricts the ability of the providers of online intermediation services to use such clauses except if they can justify them by invoking economic, commercial or legal considerations (Regulation 2019/1150, Article 10, Paragraph 1, last sentence.

## 5.5 *Redress Mechanisms (Articles 11–14 and 17)*

Through its commissioned surveys, the European Commission has demonstrated that many professional users (46%) experience problems or disagreements with online platforms in the course of their business relationship. Among the business users with more than half of their turnover generated via online platforms (heavy users), the share of those that experienced problems is significantly higher (75%) and almost half of them (32%) often experienced problems which caused an important percentage of them to terminate their relationship. In addition, business users complain about "overall insufficient redress mechanisms"; and "lack of an effective, accessible, reliable and quick independent redress mechanism" (European Commission 2017, pp. 24–25).

One-third of all problems in P2B relationships remain unresolved, because of fear of retaliation and the high costs incurred for SMEs while a further 29% refers to not easily or inadequately resolved disputes (Madiega 2019, p. 2; European Commission 2017, p. 24).

Therefore, the Regulation provides for redress mechanisms (complaint system and mediation), as well as actions before the national courts (including collective action). Self-regulation was not considered adequate to solve the problem (Madiega 2019, p. 10; Busch 2019). Providers of online intermediation services are:

- Required to provide an internal system for handling complaints from business users which is easily accessible and allows them to lodge complaints directly with the platform (Regulation 2019/1150, Article 11);
- Obliged to identify and provide one or more impartial and independent mediators for cases where complaints could not be resolved within the internal complaint-handling system (Regulation 2019/1150, Article 12; Anagnostopoulou 2018b, pp. 979–981);
- Encouraged to set up one or more organizations providing mediation services (Regulation 2019/1150, Article 13); and
- Encouraged to adopt and implement sector-specific codes of conduct (Regulation 2019/1150, Article 17).

In case that the above dispute-settlement methods fail, the business users may file an action before national courts. In addition, Member States must provide the possibility of collective action by non-profit independent organizations and associations or public bodies that have a legitimate interest in representing business users, or corporate website users, and are properly established in accordance with the law of a member state, before national courts in order to prohibit non-compliance (Article 14). Collective action seems to be the most effective redress mechanism.

# 6 Conclusion

Since 2010, the EU has strived to establish an integrated digital environment for the SMEs to flourish and to achieve economic growth. The EU has taken positive measures to bring technological advancements and to provide a predictable legal framework that balances the rights and interests of all stakeholders. The DSM is now a reality and not just a strategy on paper.

By completing the DSM, the EU had to deal with the dilemma of co-regulation or hard regulation of platform operators. The first phase of the EU regulatory attempt (by July 2020) covers for the first time the supply side of the contract infrastructure of the platform economy. The consumer side of the platform economy has been modernised by Directive 2019/2161 (to be applied by May 2022). The Regulation (EU) 2019/1150 focuses on Internet Service Providers acting as intermediaries in transaction platforms and search engines leaving outside its scope sharing economy platforms, payment systems and advertising platforms. The Regulation seems to have limited the immense power of most of the colossal platform operators, since it applies to the US- or China- established platform operators for the goods they sell and the services they render in the EU through EU established business users. They must revise their rules and membership agreements, ranking policies and data collection practices to make them transparent and fair towards business users, usually SMEs. At the same time they can serve their trade interests because of the predictable uniform legal environment in a digital single market of 500 million consumers. The power of online intermediaries is also limited by the possibility of collective actions by business users and websites filed against them in case they fail to meet their obligations, imposed by the Regulation. The consumer side of the contract infrastructure has been harmonised by Directive 2019/2161 which leads to better enforcement and modernisation of consumer protection rules.

Overall, the Regulation is a piece of the already established “ecosystem” of e-commerce, consumer protection and competition rules. In this way, the Regulation 2019/1150 protects the SMEs against the abuse of power of online intermediaries and may lead to inclusive and fair growth.

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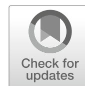
# SMEs and State Aid




**Eftychia Mouameletzi**

**Abstract** The present chapter discusses the relationship between small and medium enterprises and state aid. SMEs are very essential to promote competitiveness, job creation, economic growth, social stability and a spirit of entrepreneurship and innovation throughout the EU. For that reason they are at the focus of EU policy which aims to benefit them by granting them the SME bonus, which in essence means more and easier State aid. It is therefore deemed important that an SME is properly classified as such, according to the provisions of Commission's Recommendation 2003/361/EC on the SME definition, in order to have preferential access to state aid for investment and other activities. In this context, anti-circumvention measures have been established to prevent abuse of the SME definition and reserve the benefit of the SME bonus to genuine SMEs. EU Commission's practice and EU case-law on the SME definition have greatly contributed to this purpose.

## 1 EU State Aid Policy

Article 107(1) TFEU defines State aid as "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods in so far as it affects trade between Member States." So, there are four cumulative conditions for State aid to exist in a liberalized economic sector or market where there is or could be competition. Distortion of competition is exceptionally excluded if a service is under legal monopoly and does not compete with similar (liberalized) services or when the service provider cannot be active (due to regulatory or statutory constraints) in any other liberalized market.

All data included in the present contribution refer to research done until May 2016.

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State aid policy of the European Union relies on the “incompatibility principle”, according to which distortion of competition is generally assumed when a Member State grants a financial advantage to an undertaking. However, it is exceptionally accepted that State aid is allowed as compatible if its positive impact in terms of increased economic activity outweighs its negative effects in terms of restrictions on competition and trade. These exceptions apply when there is a need to promote the economic development of areas where the standard of living is abnormally low or when there exists serious underemployment or in order to facilitate the development of certain economic areas or sectors. The detailed State aid compatibility rules are contained in the various Commission’s legislative texts, such as the Guidelines and EU frameworks (which demand that the national measure must be notified to the Commission in order to decide on its compatibility) or the Regulations and/or Decisions exempting from notification, such as the General Block Exemption Regulation 651/2014, the de minimis rule etc.

## 2 SMEs’ Significance and Specific Problems

Small- and medium-sized enterprises (SMEs) are considered to be the engine of the European economy, since they create more than 85% of new jobs in Europe and they generate two out of every three jobs (in 2013, over 21 million SMEs provided 88.8 million jobs throughout the EU). So, SMEs are very essential to promote competitiveness, job creation, economic growth, social stability, and a spirit of entrepreneurship and innovation throughout the EU (European Commission 2015, p. 3). This is why they constitute the major focus of EU policy which aims to benefit them by granting them the SME bonus, which in essence means more and easier State aid.

The reasons for granting more State aid to SMEs lie in the problems that they confront. Their small size which represents a handicap (Quigley 2015, p. 320) in terms of:

(a) Market failures: SMEs may be unable to access finance because they are unable to demonstrate their credit-worthiness or the soundness of their business plans to investors (Guidelines on State aid to promote risk finance investments 2014, para. 3). SMEs are also usually unable to invest in research and innovation or they may lack the resources to comply with environmental regulations. State aid fills the gap created by this persistent market failure. On the contrary, large undertakings do not face similar problems for they are mostly listed on the official list of a stock exchange or a regulated market that render them able to attract private financing (Guidelines on State aid to promote risk finance investments 2014, paras. 21–22), so they do not need to be supported.
(b) Structural barriers: lack of management and technical skills, rigid labor markets and limited knowledge of opportunities for international expansion.

As the President of the European Commission, Jean-Claude Juncker, has said, “*we have to free SMEs from burdensome regulation*” (European Commission 2015, pp. 3, 5).

## 3 Categories of State Aid for SMEs

There exist several categories of compatible State aid provided for SMEs either in the General Block Exemption Regulation 651/2014 (without notification) or in the Commission's Guidelines (notification is required). The General Block Exemption Regulation 651/2014 contains a special section for SMEs (Articles 17–20) that aims to improve the general business environment via specialized consultants, training, the dissemination of advanced technology, and the improvement of production and management methods. This kind of aid is considered to be less harmful to competition and more likely to strengthen the general efficiency and competitiveness of the Community economy (European Commission 1990, point 294). Four kinds of aid fall under this category:

1. Investment aid for initial investment (land, buildings and plant, machinery and equipment, patents, licenses, know-how, or other intellectual property) or wage costs of employment directly created by the investment project.
2. Aid for consultancy by external consultants which does not constitute a continuous or periodic activity nor relate to the undertaking's usual operating costs, such as routine tax consultancy services, regular legal services, or advertising.
3. Aid for SMEs to participate in fairs. The eligible costs are those incurred for renting, setting up, and running the stand for the participation of an undertaking in any particular fair or exhibition.
4. Aid for cooperation costs incurred by SMEs participating in European Territorial Cooperation projects. The eligible costs relate to the organizational cooperation including the cost of staff and offices to the extent that it is linked to the cooperation project, to advisory and support services linked to cooperation and delivered by external consultants and service providers, to travel expenses, costs of equipment and investment expenditure directly related to the project and depreciation of tools and equipment used directly for the project.

SMEs can also benefit from the SME bonus for other categories of aid contained in the General Block Exemption Regulation 651/2014 or in the Guidelines for regional, research and development, training, environmental aid, etc.

SMEs can receive de minimis aid as well, like every other undertaking pursuant to the provisions of Regulation 1407/2013.

Finally, aid for access to finance for SMEs is provided:

(a) In a special section of the General Block Exemption Regulation 651/2014 (Articles 21–24) concerning:

- Risk finance aid in the form of equity, quasi-equity investments, loans, guarantees, or a mix thereof to unlisted SMEs that have not been operating in any market or have been operating in any market for less than 7 years following their first commercial sale or require an initial risk finance investment which, based on a business plan prepared in view of entering a new product or

geographical market, is higher than 50% of their average annual turnover in the preceding 5 years.

- Aid for start-ups: the eligible undertakings are unlisted small enterprises up to 5 years following their registration, which have not yet distributed profits and have not been formed through a merger.
- Aid to alternative trading platforms specialized in SMEs: tax incentives to independent private investors that are natural persons in respect of their risk finance investments made through an alternative trading platform into undertakings eligible under the conditions laid down in Article 21.
- Aid for scouting costs: costs for initial screening and formal due diligence undertaken by managers of financial intermediaries or investors to identify eligible undertakings pursuant to Articles 21 and 22.

(b) In the 2014 Guidelines on risk finance investments

The improvement of access to risk finance for SMEs is of utmost importance to the European economy. Due to the abovementioned difficulties that SMEs face in gaining access to finance, particularly in the early stages of their development, business finance markets may fail to provide the necessary equity or debt finance to newly created and potentially high-growth SMEs, manifesting a persistent capital market failure. This gap may justify public support measures through the grant of State aid which can be an effective means to alleviate the identified market failures and to leverage private capital (Quigley 2015, p. 326). Risk finance aid measures have to be deployed only through financial intermediaries. It is specified in the Guidelines that there exists no State aid if financing is affected *pari passu* by public and private investors. This happens when both of them intervene simultaneously, under the same terms and conditions (same risks and rewards[1]) and when the funding provided by private investors is economically significant (at least 30%) (Guidelines on State aid to promote risk finance investments 2014, paras. 31–36).[2]

In case the risk finance measures do not comply with the market economy operator test, fall outside the scope of the *de minimis* Regulation, or do not satisfy all the conditions for risk finance aid as laid down in the General Block Exemption Regulation, Member States must notify those measures. The Commission will analyze whether the design of the aid measure ensures that the positive impact of the aid toward an objective of common interest exceeds its potential negative effects on trade between Member States and competition

[1]A public investor is considered to be in a better position when it receives a priority return in time compared to private investors.

[2]Paras. 31–36 and especially fn. 26 that gives, first, an example of an economically significant private investor funding taking up one third of the total equity investments in a company (Case C 53/2006, Citynet Amsterdam, the Netherlands, OJ L 247, 16.9.2008, p. 27, Paragraph 96–100) and then the opposite example where *pari passu* conditions were not met, since the capital injected by the State (90%) was neither accompanied by a comparable participation of a private shareholder (10%) nor was it proportionate to the number of shares held by the State (Case N 429/10, Agricultural Bank of Greece (ATE), OJ C 317, 29.10.2011, p. 5).

according to the common assessment principles laid down in Chap. 3 of the Guidelines.

# 4 The SME Definition

## *4.1 Commission Recommendation 2003/361/EC*

The preferential treatment for SMEs in the form of the SME bonus constitutes, nevertheless, a prerogative, from which many enterprises would like to profit.

A common definition for SMEs arises as the necessary prerequisite for an even application of policies across the EU against the distortion of competition in a globalized business environment. Given the relative scarcity of funds and since an enterprise's size may represent a handicap, the Commission has issued the 2003/361/EC Recommendation where it sets out the SME definition in order to ensure that only genuine SMEs benefit from the SMEs advantages in terms of higher aid intensity.

The SME definition is designed to help SMEs identify themselves so that they can receive more money as State aid and also to ensure that the definition is not circumvented on formal grounds. The 2003/361/EC Recommendation sets out the following two cumulative criteria and the relative thresholds under which an enterprise is qualified as "medium" that suffers from the handicaps mentioned above:

(i) Fewer than 250 staff headcounts
(ii) Annual turnover up to 50 million euros or Annual balance sheet total up to 43 million euros, alternatively[3]

The "spirit" of the Recommendation's SME definition is to take into account an SME's ability to call upon outside finance. If an enterprise is linked to another large enterprise and exceeds the above ceilings, it could not qualify for SME status.

Deciding whether or not a company is an SME is not a simple task. In practice, it is often quite difficult to calculate a company's size, especially in the context of the complex entrepreneurial environment existing nowadays. Due to the close financial, operational, or governance relationships a company would keep with other enterprises, it might be difficult to precisely draw the line between an SME and a large enterprise.

Pursuant to the Commission's Recommendation, possible relationships with other enterprises must be taken into account to determine the aided enterprise's size. In case that such relationships create significant ownership links to large companies or if they give access to additional financial or other resources, this may mean that the enterprise is not economically independent but forms a single

[3]Furthermore, "small" enterprises employ fewer than 50 persons and their annual turnover or annual balance sheet total does not exceed 10 million euros; "micro-enterprises" employ fewer than 10 persons and their annual turnover or annual balance sheet total does not exceed 2 million euros.

economic entity with the large one and, consequently, it does not suffer from the SMEs handicaps and might not be eligible for the SME status.

To decide on the proper size of an enterprise recipient of a State aid, one must first establish its status (as an autonomous, partner, or linked enterprise) according to its relationships to other enterprises and must then calculate its data.

There exist three kinds of relationships between enterprises: autonomous, partner, and linked enterprises (European Commission 2015)[4] depending on the influence one can exercise over another's strategy and commercial decisions. A closer relationship—depending on the percentages of capital or voting rights one enterprise holds to another—leads to a greater influence which determines the company's size accordingly.

An enterprise is "autonomous": (a) if it is totally independent, i.e., it has no participation in other enterprises and no enterprise has a participation in it or (b) if it has a holding of less than 25% of the capital or voting rights (whichever is higher) in one or more other enterprises and/or any external parties have a stake of no more than 25% of the capital or voting rights (whichever is higher) in the enterprise or (c) if it is not linked to another enterprise through a natural person in the sense of Article 3.3.

An enterprise may still be considered autonomous, and thus as not having any partner-enterprises, even if the 25% threshold is reached or exceeded by any of the following types of investors: (a) Public investment corporations, venture capital companies, and business angels; (b) Universities and nonprofit research centers; (c) Institutional investors, including regional development funds; (d) Autonomous local authorities with an annual budget of less than 10 million euros and fewer than 5000 inhabitants. One or more of the above investors may individually have a stake of up to 50% in an enterprise, provided they are not linked, either individually or jointly, to the enterprise in question (European Commission 2015, pp. 16–17). This kind of relationship is not considered capable to influence the operating and financial policies of the second enterprise; consequently, only the recipient enterprise's data are taken into account.

An enterprise is a "partner" enterprise if it has a holding of 25–50% of the capital or voting rights in another upstream or downstream enterprise and vice versa. This percentage is considered to potentially influence the operating and financial policies of the second enterprise according to the wishes of the first one; accordingly, the enterprise in question must add to its data the proportion of the data that reflects the percentage of shares or voting rights—whichever is the higher—that are held in the second enterprise.

Two or more enterprises are "linked" when they have any of the following relationships: (a) One enterprise holds a majority of the shareholders' or members' voting rights (more than 50%) in another (e.g., wholly owned subsidiary); (b) One enterprise is entitled to appoint or remove a majority of the administrative,

[4]For each category see the graphics presented in pp. 16–23, enriched by useful examples in pp. 25–36.

management, or supervisory body of another; (c) A contract between the enterprises, or a provision in the memorandum or articles of association of one of the enterprises, enables one to exercise a dominant influence over the other (e.g., long-term supply agreements, veto rights on strategic decisions); (d) One enterprise is able, by agreement, to exercise sole control over a majority of shareholders' or members' voting rights in another. All the above kinds of relationship can also occur through one or more natural persons (e.g., Manager, President, shareholder having veto rights) acting jointly (e.g., family links), provided that they operate on the same or adjacent markets (e.g., car production and car sales to final consumers). This third kind of relationship is considered important since all linked enterprises form in essence a single economic unit bearing common economic interests and exhibiting a uniform commercial behavior. Consequently, the total data of the linked enterprises must be added to those of the enterprise in question, in order to determine if the latter remains within the SME's thresholds.

It must be pointed out that it is possible that an enterprise which might seem "autonomous" at first sight to be finally considered "linked" to a group, if its shareholders are themselves linked to each other, thus forming a group of linked enterprises. This case illustrates how the Commission's Recommendation on the SME definition tries to prevent its abuse by enterprises looking to circumvent it.

## 4.2 EU Case-Law and Commission's Practice on the SME Definition

The recent "HaTeFo" case (HaTeFo GmbH v Finanzamt Haldensleben 2014), which was brought before the ECJ through a preliminary ruling request from the Bundesfinanzhof (Germany), is an illustrative example of a group of natural persons acting jointly. The HaTeFo company, a legal person producing plastic foils, sheets, tubes, and moldings, was owned by three shareholders natural persons (A, B who was A's spouse, and C), who hold, respectively, 24.8%, 62.8%, and 12.4% of the shares. A and C are managing directors of that company. In addition, A and his mother D have equal shares in company X, to which A and C are also managing directors. In addition, HaTeFo and X had concluded a business management contract, pursuant to which all of HaTeFo's orders were to be taken by X, which would be the only company with a presence on the market. That business management contract also stipulated that a representative of X was to take charge of HaTeFo's technical management.

Furthermore, HaTeFo transferred its research and development activities and its computer management to X, and it used one of X's bank accounts for the purposes of its activities. Considered in isolation, HaTeFo was an SME and could profit from the SME bonus for an investment subsidy. However, the ECJ considered that these two companies form a single economic unit, since (a) they are owned and controlled by just four individuals, three of whom (A, B, and D) are closely related through family

links and act jointly, since they work together in order to exercise an influence over the commercial decisions of both enterprises concerned and (b) through the business management contract they cooperated in the same market dividing between them production and sales; this precludes those enterprises from being regarded as economically independent, without being necessary that any contractual relations exist between them or that they intend to circumvent the SME definition.

A similar case C-91/01, Italy v Commission (2004, p. 18),[5] has been brought before the ECJ via an application for annulment of Commission Decision 2001/779/EC on a State aid which Italy was planning to grant to "Solar Tech" (a company active in the solar systems industry) for the construction of a plant to produce amorphous silicon film and integrated solar panels located in the municipality of Manfredonia in the region of Puglia, insofar as it did not allow the application to that aid of the SME bonus of 15% gross grant equivalent.

According to the Commission's view, from an economic standpoint, Solar Tech has to be regarded as belonging to the Permasteelisa Group, a large firm and a world leader in the production of curtain walls and other cladding materials for large infrastructure projects, despite the fact that Permasteelisa SpA (the enterprise heading the Permasteelisa Group) holds just 24% of the shares in Solar Tech (therefore less than 25%, which implies an autonomous undertaking at first sight). But thanks to the economic, financial, and organizational links between the two companies, Solar Tech does not suffer from the SMEs' usual handicaps and, consequently, it does not fulfill the necessary conditions to qualify for the SME bonus.

The ECJ upheld the Commission's decision, noting that all Solar Tech's shareholders are also closely connected to the Permasteelisa Group itself or to companies belonging to this Group, either via shares or via influential positions held within it: (1) the founder and reference shareholder of the group, who acts as the group's chief executive officer, holds 46% in Solar Tech and is its sole director, (2) the chairman of the group holds 15% of the shares in Solar Tech, and (3) one of the members of the board of directors of Permasteelisa, who is also chairman of another company belonging to the group, holds the remaining 15% of Solar Tech's shares.

The Permasteelisa Group invested in Solar Tech because it wished to extend its range of products through this project. Moreover, the Commission and the Court checked that as far as capital is concerned, Solar Tech would be able to raise the funds it needs on the basis of Permasteelisa's financial standing, could have access to partners with the necessary technology via its three shareholders who are also executives of the Permasteelisa Group, and that, as regards product distribution, Italy has stated that Solar Tech will sell part of its production (20–30%) to Permasteelisa and will be able to benefit from the latter's contacts with a number of clients in the property sector, which will enable it to supply the worldwide market. The above led the ECJ to the conclusion that the SME bonus of 15% gross grant equivalent could not be applied in the case in point.

[5]To be noted that this case has been ruled under the previous Commission's Recommendation 96/280/EC which was in force at the time. See also Kekelekis (2008, p. 18).

Finally, the Commission decision 2006/904/EC on State Aid No C 8/2005 (ex N 451/2004) deals with Germany's notification of its plan to grant State aid to the company Nordbrandenburger UmesterungsWerke (NUW) (European Union 2006; Kekelekis 2008, p. 17) as an SME for the construction and operation of a biodiesel fuel plant. NUW was a manufacturer of biodiesel fuel plants. The Commission opened the formal investigation procedure because it doubted whether NUW would be eligible for the notified SME bonus since it did not seem to comply with the definition of an SME under the SME Recommendation.

Indeed, to the view of the Commission, NUW was maybe linked to 15 other enterprises through members of the Sauter family, which consisted of just six natural persons that resulted in joint activities in the same or adjacent markets (transport, real estate, and wind energy). Accordingly, the Commission realized that due to the long-existing business relationships (supply of their products to another company of the group) and organizational links across the 15 companies based on a common history and a planned joint development, the Sauter family could easily coordinate not only their daily operational activities but also their strategic development as a group. In addition to this, the companies were presented as the "Sauter Group" on the Internet. Several companies of the group had also the same customers and suppliers and the staff was changing positions across the different companies. Therefore, to calculate the size of the recipient undertaking, all companies of the group ought to be taken into account. In this case, the sum of all relevant data exceeded the SMEs' thresholds and, consequently, NUW could not benefit from the SME bonus.

## 5 Conclusion

State aid for investment and other activities as well as for access to finance for SMEs presupposes the proper classification of an enterprise as an SME according to the provisions of the Commission's Recommendation 2003/361/EC on the SME definition. In order to reserve the benefit of the SME bonus to genuine SMEs, anti-circumvention measures prevent the abuse of the SME definition. Apart from this prerequisite, the SME beneficiary of the aid must also respect the conditions contained in the General Block Exemption Regulation or in the Commission's Guidelines so that it receives a compatible State aid which is all the more important for its competitiveness.

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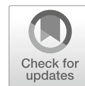
# Funding from EU Structural Funds Towards SMEs: Findings and Suggestions on Increasing SMEs Financial Capacity



**Dimitrios Skiadas**

**Abstract** The paper focuses on the financial support provided, in terms of both funding schemes as well as actual funds, by the Structural Funds to Small- and Medium-Sized Enterprises (SMEs), within the Cohesion Policy Framework. For this purpose, a special report of the European Court of Auditors is employed, focusing on the EU financial instruments for SMEs which were co-financed by the European Regional Development Fund (ERDF). The findings of the report are being examined not only as evaluation results for the past but also as crucial elements to be taken into account for the preparation of the corresponding actions of Cohesion Policy within the 2014–2020 programming period.

## 1 Introduction: Definition of SMEs

It is common ground that Small- and Medium-Sized Enterprises (SMEs) are the backbone of the economy in the European Union. SMEs are defined (European Commission 2015) by establishing their nature as enterprises by using as distinctive criteria the number of their employees, the level of their turnover, and the size of their balance sheet, and by applying the corresponding thresholds as shown in Table 1.

In order to verify the real nature of an SME, it is crucial to be able to distinguish whether an enterprise is related to another in order to establish a clear picture of an enterprise's economic situation and to exclude those that are not genuine SMEs. The relevant distinctions entail (a) the autonomous enterprises which are either completely independent or have one or more minority partnerships (each less than 25%) with other enterprises, (b) the partner enterprises whose holdings with other enterprises rise to at least 25% but no more than 50%, and (c) the linked enterprises

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**Table 1** Definition of SMEs

| Category | Number of employees | Turnover | Balance sheet |
|---|---|---|---|
| Micro | <10 | <2 million euros | <2 million euros |
| Small | <50 | <10 million euros | <10 million euros |
| Medium | <250 | <50 million euros | <43 million euros |

Source: Commission Recommendation of 6 May 2003 concerning the definition of micro-, small-, and medium-sized enterprises. (2003/361/EC), Official Journal of the European Union, L 124/36, 20 May 2003

whose holdings with other enterprises exceed the 50% threshold (European Commission 2015).

In the non-financial business sector of the 28 EU Member States, about 99.8% of the operating enterprises in 2016 and 2017 were SMEs. These SMEs employed 93 million people, a figure that accounts for 67% of total employment and generated almost 57% of value added for that sector. The majority of SMEs (exceeding 93%) were micro SMEs, employing less than 10 persons. Most SMEs are active in business sectors such as wholesale and retail trade, manufacturing, construction, business services and accommodation and food services (Hope et al. 2017).

## 2 SMEs in Europe

Following the 2008–2012 economic crisis, the European economy as a whole has entered a stage of recovery, which was measured in terms of economic added value[1] and employment. The cumulative increase of the European economy for the period 2008–2017 was 16.5% in EVA and 1.8% in employment. The SMEs in the 28 EU Member States contributed significantly in this, as they generated, for the same period, a cumulatively increased economic value added of 14.3% and a cumulatively increased employment of 2.5%. These figures accounted for 47% of the total increase in the value added generated by the non-financial business sector, and for 52% of the cumulative increase in employment in the same sector. Furthermore, it was found that the number of SMEs in the EU-28 increased by 13.8% between 2008 and 2017. And when considering this figure, it must be borne in mind that the number of newly created SMEs markedly exceeded the actual increase in SME population because of the high mortality rate of SMEs, as, in terms of statistical equivalence, each new SME that survived over the period between 2012 and 2015

[1]EVA measures the wealth a firm creates in a given period of time, as it registers the firm's net operating profit after tax—NOPAT—minus the cost of the capital used to produce that profit, i.e. the cost of capital rate multiplied by the invested capital (IC). Based on this EVA calculation, a firm creates wealth (value) if the NOPAT generated is in excess of the cost of the invested capital (for more details see Bahri et al. 2011).

required the creation of nine SMEs that did not. This indicates the SMEs' capacity for growth (Hope et al. 2018).

However, these overall results are not evenly reflected upon in the individual EU Member States. In six EU Member States (Croatia, Cyprus, Greece, Italy, Portugal and Spain) the 2017 level of SME value added was still below its 2008 level and in 15 EU Member States (Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, France, Greece, Ireland, Italy, Latvia, Lithuania, Portugal, Romania, Slovenia and Spain) the SME employment level in 2017 did not reach its 2008 level (Hope et al. 2018).

These discrepancies are quite clearly reflected in the analysis presented by ESPON in 2017, in which there is a multifaceted examination of the performance of SMEs throughout the EU and its Member States, taking into account various factors that may account for the diversification of the identified results, focusing mainly on the territorial context of the areas, in order to highlight the causes and the results in all regions of the EU Member States. Such causes include the differences that exist among EU Member States, or even among the regions within a state, with regard to critical conditions for SME development, such as education, good governance, and infrastructure, or even the variety of competencies concerning SME policy (with regard to founding regulations, market laws such as labour law or social rights, and consumer rights) (ESPON 2018). The relevant maps (Fig. 1a, b) are quite revealing for the determination of the area in which SMEs are the preferred type of business organization, due to their performance:

The most commonly identified problems that SMEs are called to face are attributed to a variety of factors, as follows (Saublens 2013):

- Inadequate shareholder's equity and difficult access to external funding sources
- Overcautious/wrong strategic choices by businesses, preventing them from up-marketing supply, from geographical/technological diversification or from "low cost"-oriented innovation and even from detection of new growth relays
- Inadequate investment in innovation, especially into generic technology and e-business
- Gaps in managing innovation
- SME size (few regions compare with the medium-sized enterprise fabric of German regions)
- Difficulty recruiting and adjusting human resources
- The first-client search
- A low propensity to develop transnational cooperation in innovation
- Inappropriate public support services

Thus, in terms of intensity (this being defined as the frequency of occurrence), the problems facing the SMEs entail the finding of customers (20%), the availability of qualified staff (17%), the extensive regulation of entrepreneurial action (16%), the constantly developing competition (15%), the access to funding schemes (13%), the cost of production and labour (12%), etc. (Avezedo and Haase 2016).

# 3 The Support Provided by EU to SMEs

In order to support the SMEs in overcoming these difficulties, the EU has employed various means, which are categorized as follows (Avezedo and Haase 2016):

(a) Regulatory measures which entail initiatives such as the Small Business Act providing for the framework of the EU policy on SMEs and defining ten guidelines linked to the "Think Small First" principle.
(b) Assistance schemes/financial support which entail (1) the thematic programmes with specific objectives and implemented by the European Commission, such as the Competitiveness of Enterprises and Small- and Medium-sized Enterprises programme (COSME) and the EU research programme Horizon 2020;

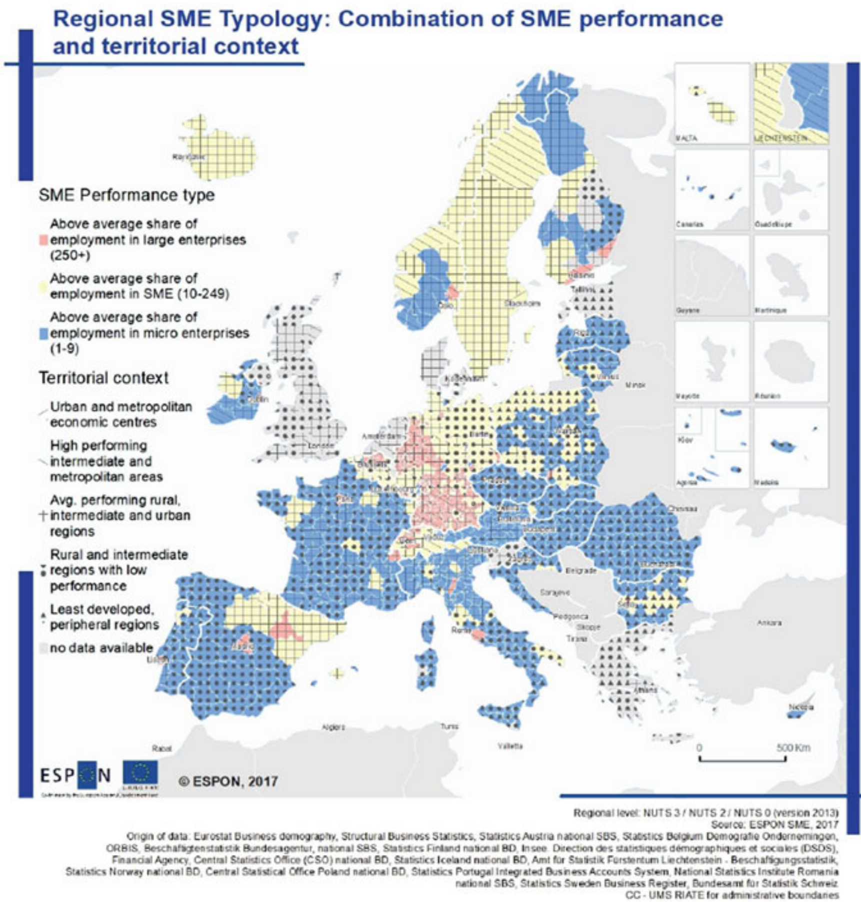


Fig. 1 (**a**, **b**) Maps of regional typology of SMEs in the EU Member States (Source: ESPON 2018)

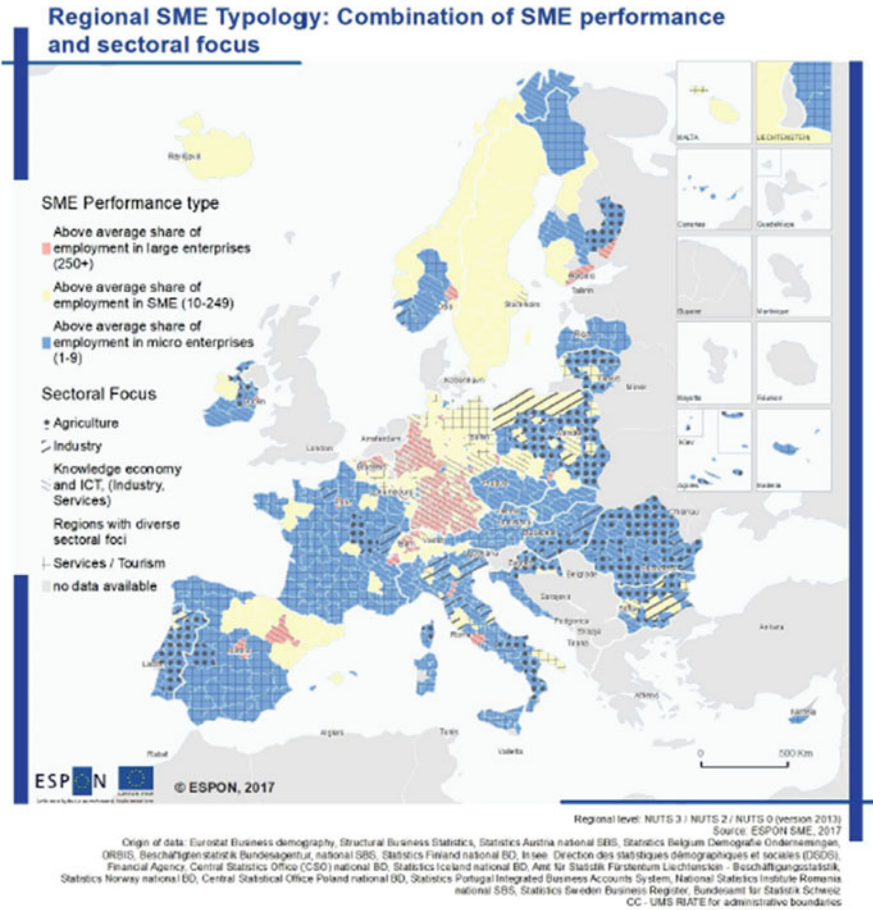


**Fig. 1** (continued)

(2) cohesion policy support through the European Structural Funds; (3) financial instruments through financial intermediaries or set up at EU level such the Loan Guarantee Facility and the Equity Facility for Growth aiming at facilitating and improving SMEs' access to finance and (4) support for the internationalization of SMEs through the European Structural Funds.

(c) Advice, support services and networking which cover many areas and policies, in some cases delivered through internet-based platforms offering information, such as the Enterprise Europe Network, the European Small Business Portal, etc.

These means are included in the overall support provided by the public authorities of the EU Member States to the SMEs, the scope of which ranges from attracting foreign direct investment to boosting enterprise creation and growth or to incentivize enterprises to align their decisions with the regional policy priorities. In 2012, the

European Commission notes that the volume of public support to manufacturing and service enterprises (especially SMEs) reached 52.9 billion euros in 2011, i.e. 0.42% of the EU GDP (Saublens 2013).

It is obvious from these findings that the main challenge that SMEs have to face, throughout the EU, and despite the regional variations, is their financial capacity. The EU interventions have focused on improving this capacity, by using novel—at least when considering EU standards—financial instruments.

## 4 EU Cohesion Policy and SMEs' Financial Capacity

The EU Cohesion Policy has been developed by establishing a series of thematic objectives, as described in the relevant Regulations. Amongst these objectives, there is one making direct reference to SMEs as it focuses on "enhancing the competitiveness of SMEs", while a few others are relevant to SMEs by referring to "strengthening research, technological development and innovation", "enhancing access to, and use and quality of, ICT", "promoting sustainable and quality employment and supporting labour mobility", etc. This relevance is explained by the fact that competitiveness for SMEs means "the advantage that a firm gains by lowering its costs, increasing productivity, improving the quality and differentiating and innovating products and services offered, and by improving marketing and branding". However, research, innovation, ICT, and quality employment, are also important drivers of SMEs' competitiveness (Avezedo and Haase 2016 and the references therein).

These objectives are realized through the implementation of specific actions, the main one being the use of new Financial Instruments. However, these actions, in order to be successful, must be implemented in a favourable institutional, regulatory framework, in the sense of increasing the SMEs' capability of having access to low-cost, fair and safe financial products (financial inclusion), as an essential condition for their development and fair participation in income distribution. The EU has introduced several relevant initiatives which may be categorized into two thematic groups: (a) initiatives implementing a new regulatory framework for a region's financial system, addressing risks and correcting weaknesses of the supervisory systems by either reinforcing market credibility and safety or strengthening consumer finance protections, and (b) initiatives focused on deepening market inclusion, by addressing poverty and social exclusion and supporting social entrepreneurship and innovation, within the Europe 2020 strategic objectives. However, the arrangements of the new economic governance framework of the EU, based on financial discipline and austerity, have limited public and private access to finance and decreased social expenditures, as the national governments' ability to provide liquidity to their economy and to stimulate credit is impeded by these new rules. Therefore finding a balance between the impacts of economic governance and the necessity of supporting the real economy has become necessary (for more details on this contradictory situation see Urquijo 2015 and the references therein).

A further demonstration of the austerity logic that prevailed over the EU Cohesion Policy may be identified in the linking of the resources provided by the EU Structural Funds with regard to SMEs' competitiveness with the EU Member States' obligation to fulfill a thematic ex ante conditionality stating that "specific actions have been carried out to underpin the promotion of entrepreneurship taking into account the Small Business Act (SBA)". These specific actions include measures aiming to reduce the time and cost involved in setting up a business, or the time needed to get licenses and permits to take up and perform the specific activity of an enterprise, etc. (Avezedo and Haase 2016).

An equally important factor that has been found to influence SMEs' access to financing, and therefore has to be taken into account by the relevant schemes of EU Cohesion Policy, is the typology of the financial institutions. The presence in the market of different types of institutions and the competition among them affects the credit availability of the financial institutions to SMEs as they seek comparative advantages in different lending technologies, and as they use very developed lending schemes entailing the information environment, the legal, judicial and bankruptcy environment, the tax and regulatory environments, etc. The fact that there are foreign-owned and state-owned institutions, as well as large and small institutions, thus forming a certain measure of financial institution concentration, is crucial as the greater presence of foreign-owned institutions and a lesser presence of state-owned institutions leads to significantly higher SME credit availability in developing nations because foreign-owned institutions appear to have advantages in using novel lending schemes which are not available to state-owned institutions. The solution is to be found in a well-balanced structure of the banking sector, entailing (a) important state banks, involved in large national projects; (b) dynamic and flexible small private banks, closed to relationship lending; and (c) a provocative foreign bank presence. Such a mixture can exploit all opportunities on the economies, creating a large base for meeting SME financing requirements (for more details see Badulescu 2010).

Given the multicity and the variety of financial institutions, of regulatory regimes and of banking legislative frameworks, it is of vital importance to develop an empirical taxonomy of SME financing patterns in Europe, i.e. which are the existing scheme that do actually provide funding for SMEs. The European Investment Fund (EIF) has undertaken this task. Its findings were that SME financing is not homogeneous, but there are various types of SME financing. The EIF analysis identified six distinct SME financing types in Europe: mixed-financed SMEs, state-subsidized SMEs, debt-financed SMEs, flexible-debt-financed SMEs, trade-financed SMEs and internally financed SMEs. These types differ according to the number of different financing instruments used and the combinations of their firm-, product-, industry- and country-specific characteristics. The relevant analysis is summarized in Table 2 (Moritz et al. 2015).

This diversity of financing types is also reflected in the diversity of the trends regarding the development of SME loans, during the period of recovery, after the economic crisis, i.e. post 2011. This diversity ranges from negative loan growth to a continuous decline of the outstanding stock of SME loans, and from an increase in

**Table 2** Taxonomy of SME financing patterns in Europe

| Type of SMEs | Form of financing | Characteristics | | | |
|---|---|---|---|---|---|
| | | Firm-specific | Product-specific | Industry-specific | Country-specific |
| Mixed-financed SMEs | SMEs that used a large variety of instruments with a focus on other loans (72%); only cluster with a noteworthy amount of equity financing (24%) | More often younger, small and medium-sized firms with different ownership structures; moderate past growth but with high future growth expectations and more often increased profit margins | More innovation | Most likely for construction sector | Especially in Northern European and market-based countries |
| State-subsidized SMEs | 100% of SMEs used subsidized bank loans or grants; large amount of other debt | More often small and in particular medium-sized firms; especially family firms or entrepreneurial teams; high to moderate past growth and future growth expectations with decreased profit margins | More innovation | Most likely for industry sector | Especially in Southern European, bank-based and distressed countries |
| Debt-financed SMEs | 95% of SMEs used bank loans; all types of debt used | More mature small- and medium-sized firms; especially family firms or entrepreneurial teams; low growth in the past and low growth expectations | Low innovation | More likely for industry and construction sector | Especially in Western European, bank-based and "old" EU member states |
| Flexible-debt-financed SMEs | 100% of group used short-term bank debt; some trade credit and leasing/ factoring | More mature micro firms with lower turnover; especially single-owner firms; more often high employee growth; average growth expectations | Average innovation | More likely for industry and trade sector | Especially in Western European, bank-based and "old" EU member states |

(continued)

**Table 2** (continued)

| Type of SMEs | Form of financing | Characteristics | | | |
|---|---|---|---|---|---|
| | | Firm-specific | Product-specific | Industry-specific | Country-specific |
| Trade-financed SMEs | 70% of group used trade credit and 40% leasing/factoring | More often younger (2–5 years), small firms in family hands or entrepreneurial teams; moderate turnover growth; moderate to no growth expectations | Average innovation | Most likely for trade sector | Especially in Northern and Southern European countries; more often in market-based countries |
| Internally financed SMEs | 100% of group used no external debt; 14% retained earnings | More often very young, micro, single-owner firms with high and moderate employee growth in the past; no turnover growth and expectation to stay the same size | Low innovation | Most likely for service sector | Especially in Eastern European, former socialist countries |

Source: Moritz et al. (2015)

outstanding SME loans to significant loans' growth, depending on the country. The consistency, however, between the course of GDP growth rate and the pace of credit expansion, during the years of recovery was not verified completely as in several countries, although economic growth recovered to some extent, the lending activity towards SMEs, in several countries, did not follow, and, on occasions, this activity declined even further (for more details see OECD 2015).

In any case, one major finding of the aforementioned taxonomy is that government support programmes (and, in that sense, the same applies for the support provided by the EU through co-financed and jointly managed schemes such as the EU Cohesion Policy) can only be effective if they support access to financing instruments that consider both, the specific characteristics of SMEs and their demand for finance as well as the supply conditions. The lack of homogeneity in SME financing in Europe leads to various financing instruments being considered as substitutes and complements in SME financing. However, the government's support programmes have a positive influence on the firms' access to finance, as the involvement of government agencies provides a positive signal for other capital providers, especially financial institutions, which would be, otherwise reluctant to support SMEs which usually have a high level of innovation activities, high growth rates and decreased profitability (Moritz et al. 2015).

Consequently, introducing the use of financial instruments as a means of providing support to SMEs, through the EU Cohesion Policy funding schemes, has been a, more or less, anticipated political choice. Financial instruments are used increasingly as an efficient alternative or in a complementary way with traditional grants. Subject to feasibility, financial instruments are applied to the full spectre of policy objectives, supporting projects that demonstrate appropriate repayment capacity in situations of market imperfection. They are deployed by the Member States and managing authorities either as tailor-made instruments or on the basis of predefined models for national or regional instruments that allow for efficient roll-out of operations in line with standard terms and conditions proposed by the European Commission. Managing authorities also contribute to financial instruments set up at the EU level, with resources that are ring-fenced for investments in line with the programmes concerned (Mente and Diegelmann 2013).

The financial instruments that are being used within the EU Cohesion Policy include the following: loans, loan guarantees, equity (venture capital), micro-finance, mezzanine finance, and various forms of revolving assistance. Their revolving nature is of significant importance for the European Commission as it allows the use of the same capital several times, thus increasing its impact and the sustainability of the instruments, and obtaining added value greater of the typical grants (Kalvet et al. 2012 and the references therein).

Over the two previous programming periods (2000–2006 and 2007–2013), in the context of EU Cohesion Policy, the European Commission encouraged such repayable forms of assistance through financial engineering instruments, by committing about 12 billion euros of the EU budget in favour of financial engineering measures across the EU Member States; 1.6 billion euros (2000–2006) and 10.4 billion euros (2007–2013), out of which, respectively, 1.5 billion euros and 7.9 billion euros in payments to holding funds or funds contributing to financial engineering instruments (European Court of Auditors 2012). Thus, by 2011, around 5% of European Regional Development Fund (ERDF) allocations had been committed in the form of different types of financial instruments, all Member States have at least one fund in place for enterprises and the relevant investment activity affected over 20,000 businesses.

More specifically, a total of 592 financial instruments (68 holding funds and 524 specific funds) had been set up through 178 operational programmes in most Member States. The relevant contributions of the Operational Programmes amounted to 10,781 million euros. Of this amount, just over a half (5.629 million euros) was allocated to holding funds, with the remainder (5.151 million euros) was allocated directly to specific funds set up without holding funds. It is noteworthy that the EU Cohesion Policy's support to financial instruments included 388 million euros from European Social Fund Operational Programmes through a variety of financial products, including micro-credit loans targeting specific populations, such as self-employed, long-term unemployed and women. The reported management and cost fees of all the schemes entailing financial instrument scheme accounted on average for 2.49% of the Operational Programmes' contributions made in the period 2007–2011, with an average of 2.63% for holding funds, 3.41% for specific funds

operating under a holding fund and 2.03% for specific funds operating without a holding fund (for more details see Kalvet et al. 2012; European Commission 2012).

## 5 The Audit of the European Court of Auditors

The constantly growing popularity in the use of such financial instruments within the framework of EU Cohesion Policy, as well as the correspondingly increased amounts provided for these schemes, attracted the interest of the European Court of Auditors that performed an audit on them focusing on assessing whether ERDF spending on financial engineering instruments for SMEs has been effective and efficient. More specifically, the following issues were addressed: (a) the quality of the assessment of the SME financing gap (i.e. the exclusion of SMEs from sources of funding); (b) the suitability of the ERDF framework to implement financial instruments and (c) the effectiveness and the efficiency of the financial instruments in achieving results (European Court of Auditors 2012).

At first, the Court established the flow of funds from the Operational Programmes of the EU Cohesion Policy to the financial instruments as shown in Fig. 2.

Based on this scheme, the Court examined the quality of the gap assessments and, in particular, whether the gap assessments: (1) identified and quantified the need for public sector action in favour of financial engineering measures for SMEs; (2) were linked with the related operational programmes; (3) were made available sufficiently in advance to all stakeholders concerned. Its findings were that for the 2000–2006 programming period there were no SME financing gap assessments, as there was no obligation (not even in the form of recommendation), to undertake them. For the 2007–2013 programming period, despite the lack of legal basis, there have been SME finance gap assessments that were supposed to be used in preparing the actions included in the Operational Programmes aiming to improve SMEs' access to finance. Despite the conclusion reached that there was a need for public sector action in favour of financial engineering for SMEs, no clear link was established between the gap assessments and the ERDF operational programmes and, thus, the relevant managerial issues (such as allocation between different types of instruments, territorial constraints, monitoring and reporting requirements, etc.) were not addressed and they resurfaced as unsolved problems. This was further enhanced by not publishing the full reports of the gap assessments, something that, if done, could have revealed the shortcomings in time (European Court of Auditors 2012).

As for the suitability of the ERDF framework for implementing financial instruments, the Court focused on (1) whether the legal and management frameworks took sufficient account of the specific nature of the different financial instruments, (2) whether the use of the ERDF as a mechanism for the delivery of financial instruments was conducive to sound financial management and (3) the suitability of the Commission's employed monitoring and information systems. Given that the relevant provisions did not contain any specific rule on the management of resources provided for financial instruments, the Commission managed repayable assistance to

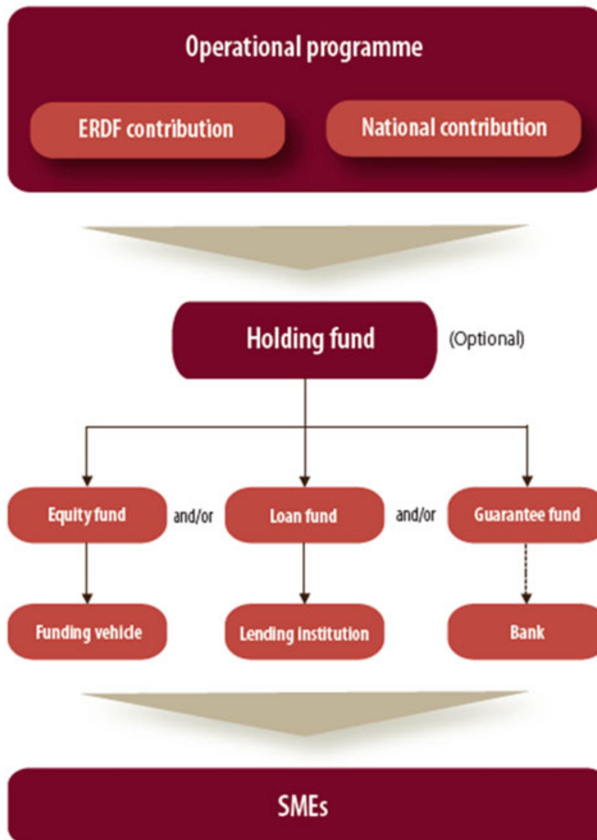


**Fig. 2** EU Cohesion funds to SMEs through financial instruments (Source: European Court of Auditors 2012)

SMEs under the same legal framework as non-repayable grants. This did not allow for improved performance of the relevant funds, and despite the Commission's interpretative intervention in 2011, there were insufficient leverage and fund revolving provisions, the allocations to financial instruments could be found as unjustified as these schemes were not subject to automatic decommitments of the corresponding appropriations, the preferential treatment in terms of getting reimbursed and receiving a better risk/return reward was granted to private sector co-funders without sufficient justification, and the eligibility conditions for working capital were not clear, requiring a case by case examination and leading to overall legal uncertainty (European Court of Auditors 2012).

Furthermore, the territorial approach adopted by the ERDF legislative framework is contrary to the approach adopted when using financial engineering instruments,

which entails the use of indicators having a national or even international reference, such as percentage of foreign equity in SME balance sheets, banking intermediation rates, default rates, loan rejection rates or equity-to-debt ratios. Finally, the combined complexity of financial instruments, shared management requirements and the state aid and Structural Funds rules necessitated specific information, and specialized communication and monitoring systems between the actors involved (Commission, the managing authorities and the beneficiaries). Despite establishing a unit responsible for SME financial instruments supported by the ERDF, the Commission failed to provide for knowledge sharing among the competent services neither specific information technology applications accessible to the Member States and stakeholders, and it tried to rectify the deficiency by asking the Member States to report on a large variety of indicators (European Court of Auditors 2012).

As for the efficiency and the effectiveness of the ERDF funding towards financial engineering instruments, the European Court of Auditors examined the delays noted in SME financing, the levels of management costs and the extent of public funds leveraging private funding. There were widespread delays across the Member States in implementing ERDF-funded financial instruments due to time-consuming structuring and negotiations, state aid issues, lack of or limited Commission guidance, not obtaining the necessary private sector contribution, administrative reasons, etc. Also, given that there were no rules preventing SMEs being charged management costs by financial intermediaries, such costs were borne by the SMEs and their extent was not known. Finally, with regard to leverage, while the Commission takes into account only the EU contribution (thus the national public co-financing is considered as a result of leverage along with private co-financing, which is an erroneous result as such co-financing is *conditio sine qua non* for the ERDF), the European Court of Auditors sums up all public funding (both national and European) seeking to identify only private co-financing. The result of the Court's method revealed that most financial instruments (except for guarantees) have very poor (if any) leverage ratios (European Court of Auditors 2012).

Based on these findings the European Court of Auditors made the following recommendations (European Court of Auditors 2012):

- SME gap assessments, with quantified analysis, should be part of the basis for proposals of financial engineering measures, as well as of the justification for the approval of the relevant operational programmes.
- The regulatory framework of the EU Cohesion Policy should include provisions more adequate for and focused on the design and the implementation of financial engineering measures, not just general provisions.
- The relevant monitoring and evaluation system should become more provide reliable, technically robust, and, more importantly, distinct from the corresponding system for pure grants, having its own measurable, specific and uniform result indicators for financial instruments.
- Reducing management costs should be dealt with by promoting the use of innovative schemes such as, for instance, conditioning the payment of the grant

to the commitment of the beneficiary SME to pay royalties in case of success, instead of charging management costs to the ERDF funding.
- Establishing one specific operational programme for financial instruments would reduce the delays in planning and implementing them, compared to using various operational programmes, with different orientations for this purpose.
- Establishing binding minimum leverage ratios, minimum revolving periods and data for the calculation of leverage indicators, and adopting uniform definitions of leverage and recycling funds.

## 6 Considerations for the New Generation of Financing Instruments

The EU Cohesion Policy is one very important funding instrument for SMEs. However, as demonstrated, its rationale and its structure have their limitations for providing support to financial engineering schemes, which are, themselves, another very useful and popular method of generating income and financial support for SMEs. In order to combine these two schemes, certain amendments in the design and implementation processes have been identified as of vital importance for their success.

Given the regional rationale of the EU Cohesion policy, a similar rationale must be developed when designing an SME policy. Such a policy should be region-specific or adjusted to the region, i.e. the strengths, weaknesses, and needs of a region and especially of the SMEs in that region should be taken into account, in order to be effective (ESPON 2018).

Furthermore, it is important to identify which measure, from those available within the EU Cohesion Policy spectre, is more suitable to address the needs of SMEs. The criteria for such process are the amount of expenditure, the type of measure (grant, loan, guarantee, etc.), the type of beneficiaries (single SME, group of SMEs, etc.) and the specific objective of intervention, in terms of the change expected to be generated on the assisted SMEs (European Commission 2014). A relevant taxonomy can be illustrated as shown in Table 3.

It is imperative for the competent authorities to be able to determine the optimal option among those available. For instance, given the administrative burden and expertise involved in setting up financial engineering instrument through the EU Cohesion Policy, such schemes may be seen as less useful in small programmes and sparsely populated areas with few SMEs and less developed capital markets. Also, the effects of the economic crisis may have undermined from the start the leverage capacity of these instruments and reduced the incentives for SME investments (Michie and Wishlade 2012).

In order to formulate a policy option that will have the possibility of being efficient and effective, it is vital to understand the objectives of both sets of actors involved in this endeavour. The public authorities, on one hand, expect enterprises to

**Table 3** Policy instruments for SMEs through the EU Cohesion Policy

| Mode of delivery | Type of beneficiary | Expected change in production inputs | Expected change in performance |
|---|---|---|---|
| – Grant<br>– Repayable financial support<br>– Information campaign, events and seminars<br>– Consulting, advice, technical assistance<br>– . . . | – Individual enterprise<br>– Individual SME only<br>– Groups of enterprises<br>– Groups of SME<br>– SMEs in partnership with universities/ research institutions<br>– SMEs in partnership with large enterprises<br>– . . . | – Increase employment<br>– Improve human capital<br>– Increase fixes capital<br>– Increase technological level<br>– Increase managerial/entrepreneurship capacity<br>– . . . | – Increased turnover (in domestic and/or international markets)<br>– Strengthened equity/ structure<br>– Increased profitability/ efficiency<br>– Increased probability of survival<br>– . . . |

Source: European Commission (2014)

align their strategy to meet the objectives set up in the Operational Programmes while the entrepreneurs, on the other hand, seek to access the right type of incentives to enhance their ability to compete in a given economic environment. In other words, the demand for support services should match the supply/offer made available by ERDF financing, and vice versa. This may be achieved by identifying the crucial factors for SMEs, namely accessing public, semi-public subsidies and capital, innovating and commercializing their RTD outcomes, taking onboard new technology and other practices, conquering markets or shortening product and service time-to-market, marketing their products and services, attracting skilled labour and improving their management, as well as those for public authorities namely creating jobs to support overall regional development, serving spatial planning aims by maintaining or supporting business activities, achieving business activation (innovation, finance, networking, etc.) and sustainable development (Saublens 2013). It is obvious that the goals of the parties involved do not necessarily coincide, as for instance developing a regional SME base could be a main priority for a public authority, but a mere incidental by-product of a profit-driven private entity which seeks an income increase and mistrusts innovative schemes (such as these promoted by EU Cohesion Policy) as potentially undermining profit. (Michie and Wishlade 2012). Such differences must be bridged.

Another element to be taken into account is that EU Cohesion Policy funding must comply—albeit through special regimes—with the State Aid rules of the Union, something that increases the complexity of the requirements for detailed implementation rules. The lack of a single coherent State Aid framework for considering financial engineering instruments leads to a highly fragmented approach that constrains the usefulness of these instruments (for more details see Michie and Wishlade 2012).

## 7 Concluding Remarks

In conclusion, providing financial support to SMEs through the EU Cohesion Policy and the EU Structural Funds, by establishing and using financial engineering instruments is not an easy task.

The variety of regions and SME type necessitate a careful examination of the existing situation and a planning process that would be based on the assumption that different types of SMEs have different needs and tailored support for SMEs should be envisaged: for instance, while most medium-size enterprises require an easier access to finance, small and micro enterprises are asking, to a greater extent, for accompanying measures, coaching and mentoring (Avezedo and Haase 2016).

Also, the fact that the EU Cohesion Policy does not have an immediate impact on the overall situation of its beneficiaries should not be underestimated. Perhaps there might be short-term positive results relating to specific issues such as personnel expenditure of SMEs; however, these results do not necessarily reflect a more global added value if they are not accompanied by more robust improvements with regard to other aspects of an SME's operation, such as, for instance, tangible assets. Such developments are not sustainable. Creating artificial job positions or other artificial increases in personnel expenditure (e.g. an increase in wages) will vanish in time if they are not accompanied by results of a more substantive nature on the SMEs' performance, pertaining to their competitiveness and overall economic growth. The long-term overall results of the interventions financed by EU Cohesion Policy are those that should be sought as added value indicators, in order to appraise these interventions' effectiveness (Cadil et al. 2017).

At the end of the day, it is interesting to know the point of view of the beneficiaries of these schemes, the SMEs, with regard to obtaining finance through financial engineering instruments funded by the EU Structural Funds. With regard to the next programming period (2021–2027), the European Association of Craft, Small- and Medium-Sized Enterprises (*UEAPME, now renamed to* SMEunited), has expressed its concerns for the Commission's proposals on EU Cohesion Policy and its interaction with SMEs. Maintaining growth and competitiveness of SMEs as an own policy objective is one of their priorities. Also, the simplification initiatives are considered as positive; however, in order to avoid multiple interpretations of the relevant complex delegated acts, it is suggested to involved the actors concerned in the relevant preparatory procedures. The proposed co-financing rates may practically exclude the less favoured territories and the smallest economic actors that would most need support for investment, in particular microenterprises. And with regard to the types of financial instruments for support measures, real flexibility is requested in conjunction with an approach based on the Only Once and Think Small First principles of the SBA, during the legislative process at all levels and the designing of programmes (UEAPME 2018).

It remains to be seen if SMEs will find in the financial engineering instruments which are funded by the EU Structural Funds an invaluable ally or an insuperable obstacle in their effort for growth and prosperity.

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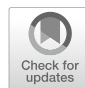
# EFSI 2.0: The Extension and Enhancement of the European Fund for Strategic Investments as a Case Study for the Review of European Policies



**Ioannis Papadopoulos**

**Abstract** The EU faces a disinvestment crisis. Its response was the European Fund for Strategic Investments (EFSI) that I first attempted to evaluate in a 2016 paper. In this chapter, I pursue the endeavor by analyzing three basic points of the EFSI, inasmuch as these are the main aspects that were found to be in need of enhancement: governance and transparency, additionality, and geographical diversification. By focusing on these aspects, I aim to assess the process used by the EU Institutions for the reform of EU policies. The chapter's conclusion is that the EFSI's strategy of risk-sharing via the use of public funds and guarantees as leverage so as to mobilize private financing in suboptimal investment situations has succeeded in crowding in significant additional finance, even though its combination with a temporary and intelligent fiscal stimulus would be more efficient in restarting the European economy. Nevertheless, the downside of this relative success is that it has proven the important leveraging capacity of an increased use of financial engineering in a constrained fiscal environment, and has consequently provided legitimacy to the EU structural pattern "Fiscal restraint/Financial ease," lessening thus the sense of urgency of an EU economic policy overhaul.

## 1 Introduction

In 2014, the European Union was facing a conjuncture whereby uncertain prospects of growth, high levels of public and private indebtedness, and their impact on credit risk had brought about a disinvestment crisis. In such a conjuncture, an increase in public and private investments is the best leverage for countercyclical policy because it augments demand in the short term (IMF 2014; Claeys et al. 2014). Combined with a midterm policy of structural reforms on the supply side, it is capable of enhancing the potential growth path. The response to this situation was the

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Investment Plan for Europe (hereinafter IPE) that the former European Commission President Jean-Claude Juncker presented on November 26, 2014 (European Commission 2014a). The central piece in the IPE is undoubtedly the European Fund for Strategic Investments (hereinafter EFSI) that was established in 2015 (Council of the EU and European Parliament 2015, pp. 1–38) as a strategic partnership between the European Commission and the European Investment Bank (EIB) Group for an initial period of 3 years, with the aim of targeting market failures, crowding in private funds, and mobilizing at least 315 billion euros in additional investments in the real economy by mid-2018.

One year later, in June 2016, the conditions for an uptake in investment had improved, even though an investment gap of about 1.7% of GDP remained for the EU (EPSC 2016), and the EU was experiencing the fourth year of moderate recovery, while on the basis of approved operations, the aggregated EIB Group investment had already catalyzed through the EFSI about 106.8 billion euros (European Commission 2016e, p. 4). According to the Commission's self-assessment, "The Investment Plan for Europe has proven to be a useful tool for delivering concrete results and encouraging a sustainable increase in the low investment levels in Europe after the financial crisis. The way the guarantee is constructed ensures an optimal use and leverage of scarce public resources to deliver tangible results for jobs and growth" (European Commission 2016c, p. 2).

Given this relative success, the Commission felt that the positive momentum generated by the Investment Plan should be maintained, and thus committed to the extension of the duration of the EFSI and to the enhancement of its financial capacity, so as to reinforce the mobilization of private investments in sectors important to Europe's future and where market failures or suboptimal investment situations remain. The result was a legislative proposal, presented in September 2016, for the extension of the duration of the EFSI until the end of the current Multiannual Financial Framework 2014–2020, i.e., until December 31, 2020, with a view to reaching a target for the full investment period of at least 500 billion euros of private and public investment (European Commission 2016d).

In a paper published in 2016 (Papadopoulos 2016), I made a first attempt to appraise the EFSI at an early stage around three axes of the Plan: its political dimension, its financial aspect, and its investment aspect. In this chapter, I intend to pursue the endeavor by analyzing three basic points of the EFSI related to the three abovementioned axes, inasmuch as these are the main points that were found to be in need of reform and enhancement: governance and transparency, additionality, and geographical coverage. By focusing on these three aspects in the form of a case study, my aim is to account for, and assess, the process used by the EU Institutions for the reform of established EU policies. More specifically, the three topics of governance and transparency, additionality, and geographical coverage in the framework of the preparation of "EFSI 2.0" (i.e., the extension and enhancement of the initial EFSI) will be used as test cases for an assessment of the effectiveness of the European political process of legislative reform, a process comprising midterm evaluation, stakeholders' opinions, and political input by the EU Institutions.

## 2 An Investment Plan for Europe in Times of Austerity: Description of the EFSI and of the Need to Extend and Enhance It

Former President Juncker's initial proposal comprised an EFSI, which initially had the ambition of mobilizing at least 315 billion euros in private and public investment across the EU in 3 years' time, in order to support strategic investments, as well as small- and medium-sized companies (SMEs) and small mid-cap companies with fewer than 3000 employees. The EFSI would finance projects with a higher risk profile, thereby maximizing the impact of public spending and unlocking private investments, and would be established within the EIB Group, with which the Commission would work as its strategic partner. The EU member states could participate in the EFSI, while participation could also open for third parties, such as National Promotional Banks (hereinafter NPBs) or public agencies owned or controlled by member states, and private sector entities. The EFSI would be endowed with an initial capital basis of 21 billion euros, comprising 5 billion in cash from the EIB and 16 billion in guarantees from the EU, mainly by redirecting funds from other EU programs such as Horizon 2020 (the European R&D framework program) and the Connecting Europe Facility (European funding for transport and energy infrastructures).

As decided by the EU Institutions, the EFSI is not a new, separate fund or legal entity, but a mechanism established for an initial period of 4 years (July 2015–July 2019) within the EIB Group by an agreement between the EIB and the Commission. It basically is a device of enhancing the EIB's risk-bearing capacity: its specific objective is to increase the volume of higher-risk projects supported by the EIB Group so as to finance operations and redress the market failure in risk-taking that hinders investment in Europe (EIB 2015). By taking on part of the risk of new projects through a first-loss liability, the EFSI would enable private investors to join under more favorable conditions. As a result, the Fund was designed to reach an overall multiplier effect of 1:15 in real investment: an initial EU guarantee not exceeding 16 billion euros would offer a specific cover to the investments financed by the EIB Group in case there are any losses. Combined with the allocation of 5 billion euros in cash by the EIB, that should generate 60.8 billion euros of additional investment. The EFSI's initial endowment of 21 billion euros was expected to further generate a total of 315 billion euros in investment in the Union within 3 years (2015–2017). In order to cover the risks relating to the EU guarantee to the EIB, a Guarantee Fund was established, which would be constituted gradually until 2022 by payments from the general budget of the Union and would provide to the EU budget a liquidity cushion against losses incurred by the EFSI in pursuit of its objectives.

As to the kind of productive and strategic investments that are supported by the EFSI, they aim at bridging the investment gap by financing and implementing projects of common interest with high economic, environmental and societal added value, in order to address market failures and complete the internal market

in transport, digital, telecom and energy infrastructures, expand renewable energy, enhance security of energy supply and energy efficiency, promote sustainable urban development, and more generally contribute to smart growth for the twenty-first century. Research, development and innovation, education and training of human resources, public health and social economy, and particular support for SMEs are targeted as well by the EFSI.

The Fund supports projects which: (a) are consistent with Union policies, (b) are economically and technically viable, (c) provide additionality, and (d) maximize, where possible, the mobilization of private sector capital. More specifically, the eligibility criteria for EFSI financial support are: (a) economic and technical viability of the projects selected according to cost–benefit analysis following EU standards; (b) consistency with Union policies, notably the Europe 2020 Strategy (smart, sustainable and inclusive growth), quality job creation, and economic, social, and territorial cohesion; (c) additionality, by enlarging the EIB's scope of action to projects with a higher risk profile than those covered by its normal operations; and (d) maximization, by leveraging, of the mobilization of private capitals. Legal security for investors is assured by the agreement signed between the Commission and the EIB on the establishment of the EFSI on July 22, 2015 and based on the requirements of Regulation (EU) 2015/1017 (the EFSI Agreement),[1] which contains, inter alia: (a) detailed requirements for EIB financing and investment operations, (b) a scoreboard of the key performance indicators to be used for assessing the macroeconomic impact of EFSI investments, (c) the procedure for project selection, and (d) provisions on the intellectual property of the funded projects (see European Commission 2015c).

Former President Juncker has clearly said from the beginning that the IPE would have to coexist with the continuing tight fiscal policy in the EU. But even though the Plan undoubtedly was an important first step toward the inversion of the disinvestment tendency in Europe, it would inevitably be thwarted, or at a minimum impeded, if austerity policies were to continue unabated: A study for the Foundation for European Progressive Studies has found that the stimulus effect on the European economy will be neutralized, to some extent, by the continuing cuts in national public investment programs (Cozzi et al. 2014). In stronger terms, a study carried out for the French Economic Observatory a year after the initiation of the IPE developed a simulation of the Plan's economic impact and concluded that if the IPE had been implemented sooner, it would have helped to significantly shorten the recession in Europe, and that the EU authorities should have implemented a much bolder plan because the IPE will likely not be effective at all (Le Moigne et al. 2016).

Against these concerns, the Plan's correct philosophy of "crowding in" (i.e., of the attraction of private investments through leverage) would probably not develop its full potential if the initial capital contribution to the EFSI remained very low. In another study (Cozzi and Griffith-Jones 2015), the authors show that an increase of

[1]For the terms of the EFSI Agreement, see Council of the EU and European Parliament (2015, Article 4).

10 billion euros of contributions in cash (and not in guarantees) by the EIB would add 180 billion euros in loans for investments, both to the public and to the private sector. That would enhance the EIB's role in the funding of vital sectors of the economy, such as energy efficiency, renewable energy sources, and the technological upgrade in gross fixed capital formation, and to an increase in lending to the SMEs, thus producing more and better jobs.

After the first year of operations considered as successful by the European Commission, the decision was made to propose an EFSI 2.0 so as to reinforce the Fund's mechanisms for the leveraging of private investment capitals in key sectors in Europe, where market failures or suboptimal investment situations remain. It is rather obvious that long-term security for potential investors was the main driving force behind this decision: "EFSI is therefore delivering concrete results and encouraging a sustainable increase in the low investment levels in Europe after the financial crisis. To further boost investment, to avoid disruptions in financing and to assure project promoters that they can still prepare projects even after the initial investment period, the Commission proposes to extend the EFSI over time and to increase its fire power" (European Commission 2016f, p. 2; see also Deutsche Bank 2016). In order to assess the effectiveness of this reform effort, I shall now discuss consecutively its three main aspects, namely governance and transparency, additionality, and geographical coverage.

## 3 The Plan's Political Dimension: Governance, Transparency, and Accountability

One of the basic questions that the IPE had to answer from its inception was whether the Plan's democratic accountability was sufficiently developed. The EFSI has been designed to possess a two-tier governance structure revolving around a Steering Board and an Investment Committee, with a Managing Director as the link between the two (Council of the EU and European Parliament 2015, rec. 29–30 and Article 7). In a nutshell, the EFSI's governance structure since the initial Regulation is the following: The management, the strategic orientation and asset allocation, and the general investment policy of the EFSI are at the hands of a Steering Board deciding by consensus and controlled by the European Commission and the EIB. The examination and approval of particular investment operations on a merit basis belong to an Investment Committee composed of independent professionals and deciding by majority. A European Investment Advisory Hub (hereinafter EIAH) supports the Steering Board for the identification, preparation, and development of investment projects, and also provides support (including in legal issues) for project financing.

More specifically, in the initial Regulation, the Steering Board (Council of the EU and European Parliament 2015, rec. 29 and Article 7(3)) comprised four members, three appointed by the Commission and one by the EIB, and sets the strategic

orientations of the EFSI, its risk profile and the rules necessary for its functioning. It takes decisions by consensus and regularly consults stakeholders. The Steering Board elects a Chairperson from among its members for a fixed term of 3 years, renewable once. The Investment Committee (Council of the EU and European Parliament 2015, rec. 30 and Article 7(7–12)) is composed of the Managing Director and eight independent experts, representing a high level of relevant market experience in project structuring and financing and a broad range of expertise. The Investment Committee's members are appointed by the Steering Board following an open and transparent call for a fixed term of 3 years, renewable once. Based on the EFSI Investment Guidelines (Annex II), they take decisions on the use of the EU guarantee for potential projects and for the operations with NPBs or Investment Platforms by simple majority and without seeking or receiving instructions from the EIB, the institutions of the Union, EU member states, or any other public or private body. The Managing Director (Council of the EU and European Parliament 2015, rec. 29 and Article 7(5–6)), who is selected by the Steering Board and approved by the European Parliament, is responsible for the day-to-day management of the EFSI, carries out the preparatory work, and chairs the meetings of the Investment Committee. Finally, the EIAH (Council of the EU and European Parliament 2015, rec. 49–50 and Article 14) builds on the existing expertise of the Commission, the EIB, NPBs and the managing authorities of the European Structural and Investment Funds (hereinafter ESIF) so as to provide strengthened support for project identification, preparation, and development, and serves as a single point of entry for technical assistance for investments within the Union. The EIAH is designed to be easily accessible, since the fees it charges SMEs for its technical assistance in addition to existing Union programs are capped at one-third of their cost, whereas its expertise is provided free of charge to public project promoters so that they fulfill the eligibility criteria set out in the EFSI Regulation. The Union contributes up to a maximum of 20 million euros per year to cover the costs of EIAH operations until December 31, 2020, without prejudice to funds already available under other Union programs. The Commission has concluded an agreement with the EIB for the implementation of the EIAH within the EIB (EIAH Agreement).

In my first foray into the EFSI (Papadopoulos 2016), I considered the Plan's governance structure as sound, since it combines the community aspect via the Steering Board, where the Commission and the EIB have a controlling power and the European Parliament has an observer role, and the independence and investment expertise of the Investment Committee and of the EIAH. Of particular interest to me was that the Steering Board's members do not originate from the member states, but only from the Commission and the EIB, and that they reach decisions by consensus so as to avoid intergovernmental fault lines in decision-making. Another sign of the Steering Board's community philosophy is that when it appoints the experts of the Investment Committee, it makes sure that the Committee's composition is diversified so as to ensure that it has a wide knowledge of the general objectives to be supported by the EU guarantee, as well as of the geographic markets in the Union (Council of the EU and European Parliament 2015, Article 7 (8)). As for the Investment Committee, the Regulation requires that "When participating in [its]

activities [. . .], its members shall perform their duties impartially and in the interests of the EFSI" (Council of the EU and European Parliament 2015, Article 7 (9)). Its operational independence is secured by adequate organizational arrangements on top of the analytical, logistical, and administrative support provided to it by the staff of the EIB. I am of the opinion that this twofold structure is fit to avoid political influences and to instill impartiality in the strategic asset allocation and the operating policies and procedures of the EFSI.

It is noteworthy that most of the political groups in the European Parliament supported the Plan, but objections were initially voiced that in the Commission's legislative proposal the Parliament was not sufficiently involved as a stakeholder in its management and that the EFSI's democratic control and accountability were not adequately developed. These objections were since assuaged by the final act's provisions on reporting, transparency, and accountability following amendments by the European Parliament.[2] The general principle of democratic accountability and economic sustainability of the EFSI's operations is stated as follows: "The EIB should regularly evaluate and report on operations supported by the EFSI with a view to assessing their relevance, performance and impact, including their additionality and added value, as well as to identifying aspects that could improve future activities. Such evaluations and reporting should be made public and contribute to accountability and analysis of sustainability" (Council of the EU and European Parliament 2015, rec. 47). The EIB submits an annual report to the European Parliament and the Council, which is made public, on EIB financing and investment operations. By March 31 of each year, the Commission submits to the European Parliament, the Council and the Court of Auditors, in the context of the financial statements of the Commission, the required information on the situation of the Guarantee Fund, and by May 31 of each year, the Commission submits to the European Parliament, the Council and the Court of Auditors an annual report on the management of the Guarantee Fund in the previous calendar year. At the request of the European Parliament or of the Council, the Chairperson of the Steering Board and the Managing Director report to the requesting institution on the performance of the EFSI, including by participating in a hearing before the European Parliament within a fixed period. At the request of the European Parliament, the President of the EIB participates in a hearing of the European Parliament that concerns EIB financing and investment operations under the EFSI Regulation, and even has to answer to written or oral questions addressed to him by the Parliament or the Council.

It is also after political pressure from the European Parliament that two slight changes in the governing structure of the EFSI have been voted under EFSI 2.0.[3] The

[2]On the reporting and accountability requirements see Council of the EU and European Parliament (2015, rec. 47, 58 and art. 16–18).

[3]As Bas Eickhout MEP said, speaking on behalf of the Verts/ALE Group in the plenary session of the European Parliament of December 12, 2017, "In the end, what is important for us as Parliament is to keep our control on the EIB" (European Parliament 2017). Nevertheless, the effort of the Parliament's co-rapporteurs José Manuel Fernandes and Udo Bullmann to render the Managing Director of the EFSI directly accountable also to the European Parliament regarding the work of the

composition of the Steering Board has increased from four to five members, and now also includes one expert appointed as a nonvoting member by the European Parliament, who acts in full independence. Furthermore, the Managing Director participates in the meetings of the Steering Board as an observer and reports every quarter on the activities of the EFSI to the Steering Board.[4] Combined with the new clauses on reporting (see below), these provisions clearly reinforce both the democratic accountability of the EFSI and its functional efficiency via the strengthening of the mediating role of the Managing Director at the intersection between the Investment Committee and the Steering Board.

Even though the EFSI was ramped up in a short period of time and its governance structures were put in place swiftly (EIB 2016b, pp. III, VII), the initial EFSI Regulation's provisions clearly showed a heightened concern for the transparency and democratic accountability of the IPE. All the independent evaluation reports by the EIB that assess the mechanism's impact and practical results are to be provided on a regular basis to the European Institutions (European Parliament, Council, and Commission) (Council of the EU and European Parliament 2015, art. 18(5)), and the EIB has to disclose on its website information relating to all EIB financing and investment operations, in the name of transparency (Article 19). All in all, it can be said that the EFSI, as designed, enjoys a sound governance structure, combining community spirit, technocratic efficiency, independence of action, and accountability to the EU Institutions and to the European citizens at large.

Yet, the enhancement of transparency in investment decisions and governance procedures was one of the basic aims of the proposal for an EFSI 2.0 (European Commission 2016f, p. 2). According to the legislative proposal of September 2016, the Investment Committee has to further explain in its decisions, which are made public and accessible, the reasons why it deems that a particular operation should benefit from the EU guarantee, in particular as regards additionality. In addition, the scoreboard of indicators needs to be published—but without containing commercially sensitive information—once an operation under the EU guarantee is signed.[5] Moreover, the proposal also includes an obligation for the EIB and the European Investment Fund (EIF) to inform the final beneficiaries, including SMEs, of the existence of EFSI support (European Commission 2016a, p. 8). Stakeholders were particularly keen to emphasize the importance of robust quality criteria and more transparency in the selection of projects to be supported by the EU guarantee, in

Investment Committee chaired by him did not make it into the final legislative text adopted on December 13, 2017 (Fernandes and Bullmann 2015).

[4]Council of the EU and European Parliament (2017) *Regulation (EU) 2017/2396 amending Regulations (EU) No 1316/2013 and (EU) 2015/1017 as regards the extension of duration of the European Fund for Strategic Investments as well as the introduction of technical enhancements for that Fund and the European Investment Advisory Hub* OJ L 345 (December 13, 2017), pp. 34–52, Articles 1(5)(b) amending Article 7(3) and 1(5)(c) amending Article 7(5) of Regulation (EU) 2015/1017.

[5]Regulation (EU) 2017/2396, Recital 25, Article 1(5)(g) amending Article 7 Paragraph 12, and Annex amending Annex II Section 5 of Regulation (EU) 2015/1017.

particular as regards the provision of additionality (European Commission 2016d, p. 6; European Commission and EIB 2016, p. 12; Claeys and Leandro 2016).

In EFSI 2.0, the scoreboard of indicators, that the Commission is empowered to establish as a delegated act prepared in close dialog with the EIB, occupies a particularly important position in the overall governance scheme of the EFSI and is clearly associated with the enhancement of transparency and accountability, since it is henceforth used as an independent and transparent assessment tool for the Investment Committee to prioritize the use of the EU guarantee for operations that display higher scores and added value. Moreover, the Steering Board is called to establish, in the strategic orientation of the EFSI, a minimum score for each pillar in the scoreboard, with a view to enhancing the assessment of projects. Thus, not only the Investment Committee will be capable of ensuring an independent and transparent assessment of the potential and actual use of the EU guarantee, but also the Steering Board may, upon request from the EIB, allow the Investment Committee to examine a project whose score in any of the pillars of the scoreboard is below the minimum score when the global assessment concludes that the operation related to that project would either address a significant market failure or present a high level of additionality.[6]

For accountability purposes, all the decisions of the Investment Committee as well as the scoreboards relating to these decisions are henceforth transmitted to the European Parliament, to the Council and to the Commission, subject to strict confidentiality requirements. At the request of the European Parliament or of the Council, the Managing Director shall report on the work of the Investment Committee to the requesting institution, and the Chairperson of the Steering Board and the Managing Director shall report on the performance of the EFSI, including, when the European Parliament makes such a request, by participating in a hearing before the European Parliament. As a logical consequence, the Chairperson of the Steering Board and the Managing Director shall reply orally or in writing to questions addressed to the EFSI by the European Parliament or by the Council within 5 weeks of the date of receipt, and the Managing Director shall reply orally or in writing to the European Parliament or to the Council to questions regarding the work of the Investment Committee.[7]

Summarily, the twofold governance structure of the EFSI, combining community philosophy with technocratic guarantees, can legitimately be considered as able to avoid political influences and to instill impartiality in the functioning of the EFSI. Both the democratic accountability and the functional efficiency of the EFSI are slightly but clearly reinforced, in conformity with the heightened concern for a transparent and efficient system of governance for the IPE. The reasons underlying the decisions of the Investment Committee have been made public and accessible,

[6] Regulation (EU) 2017/2396, Recitals 26 and 27, and Articles 1(5)(g) amending Article 7 Paragraph 12, and 1(5)(h) amending Article 7 Paragraph 14 of Regulation (EU) 2015/1017.

[7] Regulation (EU) 2017/2396, Articles 1(5)(g) amending Article 7 Paragraph 12, and 1 (12) amending Article 17 of Regulation (EU) 2015/1017.

and the scoreboard of indicators is now published. Even though there still is room to clarify and improve some aspects of the EFSI's governance (Court of Auditors of the EU 2016; EIB 2016b), all in all, the review of the EFSI's processes of governance has been successful.

## 4 The Plan's Financial Dimension: Additionality or Crowding Out Effect?

Additionality has been a key aspect of the IPE from its inception, and probably is one of the most debated issues in the political and technical discussions that have been taking place in the European Institutions, between experts, and in civil society at large. Additionality is also one of the eligibility criteria for the use of the EU guarantee, since the EFSI has been designed to target projects with a higher risk-return profile than already existing EU and EIB financial instruments, thus allowing the EIB Group to do considerably more than in the past in financing innovative, higher-risk projects (EIB 2015).

The initial EFSI Regulation defined "additionality" as "the support by the EFSI of operations which address market failures or sub-optimal investment situations and which could not have been carried out in the period during which the EU guarantee can be used, or not to the same extent, by the EIB, the EIF or under existing Union financial instruments without EFSI support" (Council of the EU and European Parliament 2015, Article 5(1)(1) and rec. 26). Of course, both "market failures" and "sub-optimal investment situations" are contested concepts that should not be too narrowly defined in a purely neoclassical spirit and on a case-by-case basis, since the aim of the IPE is to augment investment levels in Europe as a countercyclical instrument so as to combat financial fragmentation, i.e., the investment gap produced in some economic sectors and countries by macroeconomic uncertainty that is peculiar to them. It is quite remarkable, in this respect, that the EFSI Steering Board is instructed to closely monitor the developments of market conditions and of the investment environment in the member states so as to mobilize more broadly, if needed, special activities or additional financing by the EIB and NPBs or Investment Platforms (Council of the EU and European Parliament 2015, Article 5(2)).

Reversely, the so-called "crowding out effect" has also been a point of contention from the very beginning of the IPE. Indeed, an objection could be made to the IPE's financial aspect because of the danger of a possible funding competition between the Plan and several other EU policies and a crowding out effect of EU funds: It seems quite obvious that several EU member states, driven by the promise that their one-off contributions to the EFSI or to thematic or multicountry investment platforms established for the implementation of the IPE will be disregarded for the calculation of the 3% budget deficit limit demanded by the Stability Pact (Council of the EU 1997a, Article 5, b, Article 3), could draw funds from other co-financed programs to contribute to the EFSI instead. But this could bring about an important shift in the

programming of actions in the EU: The transfer of resources from some program whose funding has been determined for a 7-year period by the EU financial authority (the European Parliament and the Council) to another funding scheme (the EFSI), where no expenditures and no resource allocations are predetermined.

The very high leverage ratio of 1:15 between the EFSI's initial financial basis and the total amount of investments the latter is expected to attract (a multiplier that the EIB, based on its experience, considers as realistic) (EIB 2015), poses yet another problem: how can the EFSI "target projects with a higher risk profile than projects supported by EIB normal operations" (Council of the EU and European Parliament 2015, rec. 26) without putting at risk the EIB's conservative profile as a creditworthy bank with a triple A credit rating? Said differently, is the existence of a risk-avert banking policy that does not allow for overleveraging[8] compatible with an aggressive banking policy via the use of risk-enhancing financial instruments? Is "boring banking" compatible with a high leverage ratio of 1:15?

According to the Commission and the EIB Group, the answer is affirmative and lies, not in an increase of capital of the EIB, but in the establishment of an EU Guarantee Fund constituted by a gradual payment from the Union's budget and intended to provide a liquidity cushion for the Union's budget against losses incurred by the EFSI in pursuit of its objectives, initially based on a ratio of 50% between the payments from the Union's budget and the Union's total guarantee obligations (i.e., half of the losses from a failed investment will be covered by the Guarantee Fund).[9] In my first incursion into this subject matter (Papadopoulos 2016), I chastised the sempiternal recourse to financial engineering as a "smart use of public money to help channel private money into investments" (European Commission 2015b) in times of self-inflicted restrictive policies, instead of a straightforward expansionary fiscal policy via public investments, despite the urgent need for a dynamic countercyclical policy to counter the specter of a prolonged economic stagnation and high structural unemployment (see Majocchi 2015). The operation of the EFSI in practice seems to have shown the need for more leverage via enhanced additionality, since the fiscal strictures afflicting EU policies still remain more or less in place.

In 2017, the Regulation on the extension of the duration and the technical enhancement of the EFSI included some provisions aiming at strengthening additionality in EFSI-supported projects. In particular, the criteria specifying the financing of projects as "EIB special activities" are now explicitly considered as

[8]"The aggregate amount outstanding at any time of loans and guarantees granted by the Bank shall not exceed 250% of its subscribed capital, reserves, non-allocated provisions and profit and loss account surplus. The latter aggregate amount shall be reduced by an amount equal to the amount subscribed (whether or not paid in) for any equity participation of the Bank.

The amount of the Bank's disbursed equity participations shall not exceed at any time an amount corresponding to the total of its paid-in subscribed capital, reserves, non-allocated provisions and profit and loss account surplus" (Protocol (No 5) to the Treaties on the Statute of the European Investment Bank, Article 16(5)).

[9]EFSI 2.0 readjusted the target rate of the EU Guarantee Fund to 35% of total EU guarantee obligations (Council of the EU and European Parliament 2017, rec. 22 and Article 1(9)).

"better addressing market failures or sub-optimal investment situations" and thus as "avoiding crowding out participants in the same market" when they are duly justified. The justification of a financing operation by the EIB as a "special activity" is based, either on features of subordination in relation to other lenders, or on EIB's participation in risk-sharing instruments exposing the Group to high-risk levels, or on its exposure to cross-border infrastructure projects or to less developed and transition regions, or on its exposure to specific risks such as equity-type characteristics linking payments to performance.[10]

Indeed, the basic structure of risk allocation in EFSI projects is the following: Private investors help the EIB to mobilize investment either by buying debt or by joining its projects. The funding provided by private investors takes the form of senior debt that carries lesser risk, since losses are first absorbed by the junior debt holders; for EFSI projects, senior debt constitutes the largest source of funding. The rest of the financing is provided by the project sponsors in the form of equity or junior (otherwise called "subordinated") debt. Therefore, the more losses are absorbed by others before private investors are asked to contribute, the greater the protection provided to the latter, and therefore the more likely they are to invest in a project (EPRS 2014). Furthermore, the 2017 Regulation on EFSI 2.0 contains, for the first time, some elements as providing strong indications of additionality, notably the geographical coverage ("especially if such projects present country-, sector- or region-specific risks, in particular those experienced in less developed regions and transition regions") and the trans-nationality of the EIB special activities ("projects that consist of physical infrastructure, including e-infrastructure, linking two or more Member States").

Probably the most important reference to the function of additionality in EFSI 2.0 is the following: "However, the drive to meet the headline target should not prevail over the additionality of the projects selected. The Union is therefore committed not only to extending the investment period and financial capacity of the EFSI, but also to increasing the focus on additionality. The extension covers the period of the current multiannual financial framework and should provide at least EUR 500 000 000 000 of investments by 2020" (Council of the EU and European Parliament 2017, rec. 7). In other words, the financial operations' inherent difficulty and high added value for the EU—especially when they involve financing of physical infrastructure linking two or more member states—is sought so as not to reach simply in a bureaucratic fashion some fixed quantitative target, but instead to leverage additional resources from private investors and to bring about higher productivity and competitiveness. The same philosophy underlies the aim to obtain a wider geographical coverage of the EFSI and the so-called "blending operations," i.e., the combination of nonreimbursable forms of support and/or financial instruments from the general budget of the Union, such as the ESIF or those available under the Connecting Europe Facility (CEF) and Horizon 2020, and financing by the EFSI (Council of the

[10]Regulation (EU) 2017/2396, Article 1(3) amending Article 5 Paragraph 1 and Annex of the Regulation (EU) 2017/2396 amending Annex II Section 3 of Regulation (EU) 2015/1017.

EU and European Parliament 2017, rec. 15). Additionality is also sought through the investment scoreboard, in the sense that the latter prioritizes, as we have seen, the use of the EU guarantee for operations that display higher scores and added value[11] (Council of the EU and European Parliament 2017, rec. 26).

The EFSI has actually managed to increase the EIB's risk-bearing capacity, since the volume of its portfolio of higher risk skyrocketed from around 4 billion euros to more than 20 billion euros in only 1 year, namely 2015 (European Commission 2016a, p. 6). It has also allowed the bank to complement its traditional activities by developing new types of products allowing it to differentiate EFSI operations from its traditional portfolio and by supporting riskier projects falling under the category of "EIB special activities," i.e. activities below investment grade that have an EIB internal rating of D- or below (EIB 2016b; EPRS 2016). It is important to know that the Operations Evaluation of the EIB found that the bank goes beyond the formal requirements of the Regulation and assesses additionality for all projects, independently of whether they are special activities or not, so as to avoid risk profiles not reflecting additionality because a project could have adopted a less risky structure (EIB 2016b; EPRS 2018).

It is also important to know that the EFSI's processes do not substitute, but are accompanied by, the standard EIB processes concerning eligibility and bankability of projects. Thus, additionality is a precondition to benefit from EFSI support, but the EIB will anyhow take into consideration a number of other indicators called "pillars": the project's contribution to the achievement of the EFSI's policy objectives (pillar 1), the project's quality and soundness (pillar 2), and the EIB's technical and financial contribution needed (pillar 3). These indicators will allow the EIB to assign each project a "Value Added Score," ranging from 4 (lowest score) to 1 (highest score) (EPRS 2016).

All in all, it can be said that the principle of additionality seems to be adequately safeguarded, especially after the EFSI's reform, both at the micro-level by the Investment Committee and at the macro-level by the EIB's Board of Directors (see Deutsche Bank 2016). The Investment Committee decides on project eligibility based on the scoreboard of indicators and scrutinizes thoroughly the additionality of all EFSI operations, whereas the EIB's Board of Directors also places considerable importance on the different aspects of additionality, henceforth more clearly specified in the EFSI 2.0 Regulation (EIB 2016b).

Additionality could be strengthened even more if specific guidelines on additionality were adopted by the Investment Committee (EY 2016) and if complementarity and blending operations between the EFSI and other types of EU funding were systematized via the clarification of the rather complex EU rules in this subject

[11] "Scoreboard of indicators should be used to ensure that the EU Guarantee is directed towards projects with higher added value" (European Commission 2015a, pp. 20–24, rec. 3).

matter.[12] The EFSI's stakeholders go even further, by launching the very interesting idea of a consideration of additionality not only on the basis of the *financial* risk of projects—or portfolios—alone, but also on the basis of "the impact of EFSI-financed projects on the *real economy* [emphasis added] (. . .) as well" (European Commission and EIB 2016, p. 8).

Finally, one could also stress that transnationality and additionality of EFSI-financed projects are more closely related to EU integration than we might think if we contain ourselves to analyzing projects on purely financial terms. Cross-member state operations are not only a strong sign of additionality because of their inherently high risk, broadly due to the complexity, the very long lead-times, and the regulatory uncertainty of these kinds of projects; they are also bearers of additionality simply because of their capacity to serve as an engine of EU-wide market integration, by fostering economies of scale, leveling the regulatory playing field, and promoting the rapid take-up of state-of-the-art technologies across Europe (European Commission and EIB 2019, p. 8).

## 5 The Plan's Investment Dimension: Possible Geographic Allocation in Investment Choices

Already from the outset, the EFSI had to choose projects exclusively for their intrinsic value, with no previous sectoral or territorial allocation, so as to maximize utility (Council of the EU and European Parliament 2015, Article 7(7)). There are no quotas—regional or sectoral—and project support is demand-driven. Nevertheless, the issue of distribution of investment capital was, and still is, a crucial one in the EU: The International Labor Organization (hereinafter ILO) estimates that new credits should not be diverted from those countries and economic sectors that have the biggest need for them (such as Southern European countries, or energy efficiency projects) (ILO 2015). The standard procedures of the EIB probably do not suffice to remedy this market failure. As several working papers of the International Monetary Fund (hereinafter IMF) have shown, fiscal multipliers are state-dependent to a considerable degree and fiscal limits (i.e., the maximum level of debt in units of local goods that a government is able and willing to service) are generally lower in developing than in developed countries; when an economy is near its fiscal limits, fiscal multipliers are smaller and government consumption has a lesser expansionary effect than in low-debt states (Ilzetzki et al. 2011; Bi et al. 2014). Therefore, it is only normal that these differentials be covered by a targeted and differentiated investment policy across different EU member states by the Union's financial arm so as to

[12]The European Commission's guidelines for the coordination, synergies and complementarity between the EFSI and the ESIF are contained in a brochure published in February 2016 (European Commission 2016i).

compensate the investment gap that is brought about, to a large extent, by state-dependent distributions of fiscal limits inside the Union itself.

Indeed, the EFSI state of play of July 2016, published 1 month after the European Commission's communication prefiguring the presentation of a legislative proposal on EFSI 2.0, shows quite an important degree of geographical concentration of EIB's "special activities" (i.e., high-risk projects), since the biggest beneficiaries of the IPE were, at that time, four big national economies of the EU: the United Kingdom, Italy, France, and Spain. Out of a total financing under the EFSI of 20.4 billion euros—13.6 billion euros from the Infrastructure and Innovation Window (IIW) and 6.8 billion euros from the SME Window (SMEW)—the approved UK projects amounted to a total of 2.949 billion euros, the approved Italian projects to 2.783 billion euros, the approved French projects to 2.723 billion euros, and the approved Spanish projects to 2.512 billion euros. Thus, four out of 28 EU member states totaled, at that time, a percentage of 53.75% of EFSI financing.[13]

Should we be considering a policy of compulsory quotas here so as to target funding from the IPE toward those EU member states, regions, and/or economic sectors that suffer from the highest unemployment rates, for example? It is true that the vicious mix of downfall in aggregate demand, deflationary tendencies, and structural problems in the inducement of investments is more present in some parts of Europe, even though the maturity of the projects or their European added value is not as obvious there as they are in projects executed in other parts of Europe. Still, the idea of a form of quota in favor of countries, regions, and/or economic sectors suffering from the widest investment gap presupposes, of course, the existence of certain qualitative and quantitative indicators by which we can objectively measure the real added value of an investment in a territory so as to channel funding to the territories that need it the most. This could happen, theoretically, by using the cohesion indicators already established and used by the Commission for the purposes of the EU Regional Policy, foremost Indicator 2 "Unemployment rate" per region and Indicator 3 "Human Capital Intensity Index" per region (European Commission 2009); only, that would mean that the EFSI would function on the same basis as the ESIF, and this has been categorically excluded ever since the launching of the IPE.

Revolving around this idea, the EU Committee of the Regions, in its resolution of December 3–4, 2014 on the European Commission's Communication for an IPE, indirectly says that it is important for investment resources to be channeled in the regions where they are most needed and where they will have the biggest local or regional impact. It states that "without the regional authorities' financial and project-based involvement, the Investment Plan will not reach appropriate leverage effects into the real economy" (Committee of the Regions 2014, Point 10), and also "questions whether the envisaged 1:15 leverage ratio can be achieved throughout the EU, taking into account that some less developed regions lack a robust private

[13]In the state of play of July 2016, two member states (Cyprus and Malta) had not yet benefited at all from EFSI investment.

sector that could provide additional financing for projects" (Committee of the Regions 2014, Point 11). Underlying these assertions is a belief, albeit implicit, that more resources need to be concentrated for investments in those regions that lag behind the average investment rate of the EU, either in public or in private sector financing.[14]

In reality, both sectoral and geographical diversification of EFSI-funded projects is important for the Strategic Orientation of the EFSI, since the macroeconomic environment of projects is always taken into consideration in the planning of EFSI operations. This is done via a dedicated scoreboard providing a set of indicators related, *inter alia*, to the region where the projects are taking place. The EIB strived to ensure that, at the end of the initial investment period in 2019, a wide range of regions would have been covered and excessive geographical concentration would have been avoided (EIB 2016a). The Strategic Orientation [comprised of the EFSI Regulation, the EFSI Investment Guidelines in Annex II of the EFSI Regulation, the EFSI Scoreboard of indicators for application of the EU guarantee for the Infrastructure and Innovation Window (European Commission 2015a), and the EFSI Agreement] contains "a clear objective to avoid EFSI-supported operations from being concentrated in any specific territory" (European Commission and EIB 2015a, p. 11, 2019, p. 11). Even though the fundamental economic rationale of the EFSI is to catalyze new investments in projects and to finance SMEs and mid-cap companies that would not have been financed otherwise due to investors' risk-aversion, helping to reduce regional disparities by avoiding excessive geographic concentration is also justified from an economic point of view, since risk diversification always allows to decrease the risk of a portfolio of assets (European Commission and EIB 2015b).

More concretely, the EFSI Investment Guidelines require the Steering Board to adopt indicative geographical diversification and concentration limits and guidelines applicable to the IIW as follows. At the end of the investment period, the EFSI should aim: (a) to cover all 28 EU member states, and (b) not to use more than 45% of the total EFSI portfolio (measured by signed loan/investment amounts) in any three member states together (European Commission and EIB 2015b, p. 6).[15] Furthermore, the macroeconomic environment in which each project is taking place is also considered, according to a Scoreboard of Key Performance Indicators (KPIs) and Key Monitoring Indicators (KMIs). One of the six KMIs—that do not represent a specific target, but rather complement the KPIs in providing an aggregated picture of EIB's performance in connection with EFSI—is KMI

[14]See also: "[the Committee] suggests that the investment rate per Member State should be used as a criterion of macroeconomic surveillance" (Committee of the Regions 2014, Point 5).

[15]"Geographical Concentration": "EFSI-supported operations shall not be concentrated in any specific territory at the end of the initial investment period. To this end the Steering Board shall adopt indicative geographical diversification and concentration guidelines. The Steering Board may decide to modify these indicative limits, after consulting the Investment Committee. The Steering Board shall explain its decisions relating to the indicative limits to the European Parliament and the Council in writing. The EFSI should aim to cover all Member States." (Council of the EU and European Parliament 2015, Annex II, Paragragh 8(b)).

1 "Geographical concentration." KMI 1 is broken down by volume of operations supported by the EU guarantee by country and number of countries reached and as such, plays a prominent role in measuring the achievement of the EFSI objectives by its incorporation in regular reporting to the European Commission, the European Parliament, and the Council, as well as in evaluations, audit, and reviews of EFSI (European Commission and EIB 2015b). Thus, even though there is no quota system, the EFSI Steering Board is clearly called to take into account and monitor geographical concentration both of projects and of SME support, by receiving on a semiannual basis KPI/KMI monitoring reports including, inter alia, detailed information aggregated at portfolio level with regard to country concentration/diversification. Consequently, even though no diplomatic pressure can be exerted from the outside as to the geographical allocation of funds, the Steering Board may, in this context, review the allocation of the EU guarantee both within the IIW and between the IIW and the SMEW (European Commission and EIB 2015b, p. 14).

In the period leading to the review of the EFSI Regulation, the Commission itself agreed that geographical coverage can be further improved, and that this can be obtained by using several tools, including combining the use of the EFSI with ESIF and other EU funds,[16] setting up Investment Platforms at national, regional, and cross-border level,[17] strengthening cooperation with NPBs,[18] and using the EIAH so as to attain regions where additional outreach and technical capacity are needed[19] (European Commission 2016a, b, c, f). In EFSI 2.0, Investment Platforms are a means to bundle funds from different sources so as to enable diversified investments with a geographic or thematic focus. They are able to render smaller or local investment opportunities financially attractive to new investor groups, thus making it possible to pile up more financing in a geographically more balanced way. NPBs, on the other hand, are valuable partners in the EFSI scheme, since their national product ranges, their geographical reach, and most importantly, their local knowledge, are complementary and are certainly able to crowd in more private investors at a localized level, thus ensuring a denser geographical coverage of the EFSI tools. EU member states' NPBs are clearly encouraged to commit themselves to co-finance projects in the context of the EFSI. Finally, in EFSI 2.0 the EIAH is supposed to provide more targeted technical assistance at local and regional levels across the EU for the identification, preparation, and development of new investment projects in all regions of Europe. Thus, it is clearly capable of contributing to the geographical

[16]Regulation (EU) 2017/2396, Recital 15 and Article 1(10)(b) amending Article 14 Paragraph 2 of Regulation (EU) 2015/1017.

[17]Regulation (EU) 2017/2396, Recital 17 and Articles 1(10)(b)(ii) amending Article 14 Paragraph 2 Point (e) and 1(10)(b)(iii) adding Point (f) to Article 14 Paragraph 2 of Regulation (EU) 2015/1017.

[18]Regulation (EU) 2017/2396, Recital 17 and Article 1(10)(b)(i) amending Article 14 Paragraph 2 Point (c) of Regulation (EU) 2015/1017.

[19]Regulation (EU) 2017/2396, Recital 31 and Article 1(10)(f) adding Paragraph 6a to Article 14 of Regulation (EU) 2015/1017.

diversification of the EFSI portfolio and of extending the outreach of the EIB in general, and of the EFSI in particular, in the EU member states.

One of the novelties in the Regulation on EFSI 2.0 is that it provides guidance for the purpose of enhancing the geographical coverage of the EFSI operations to less developed and transition regions by explicitly pointing out that Investment Platforms, NPBs, and the EIAH, which are used for the promotion of a wider geographical coverage of EFSI operations, are intertwining instruments. This is evident in the clauses regarding one of the pillars of the IPE, namely the EIAH. The EIAH is henceforth encouraged to focus also on contributing actively to the sectoral and geographical diversification of the EFSI by "supporting the EIB and national promotional banks or institutions in originating and developing operations, in particular in less developed regions and transition regions, and, where necessary, helping to structure demand for EFSI support. The EIAH should endeavor to conclude at least one cooperation agreement with a national promotional bank or institution per member state. In member states where national promotional banks or institutions do not exist, the EIAH should provide, where appropriate, and at the request of the member state concerned, proactive advisory support on the establishment of such bank or institution. The EIAH should pay particular attention to supporting the preparation of projects involving two or more member states and projects that contribute to achieving the objectives of COP21. It should also actively contribute to the establishment of investment platforms and provide advice on the combination of other sources of Union funding with the EFSI. A local presence of the EIAH should be ensured where necessary, taking into account existing support schemes, with a view to providing tangible, proactive, tailor-made assistance on the ground" (Council of the EU and European Parliament 2017, rec. 31).

Another important regulatory advance in EFSI 2.0 is the explicit recognition that the expansion of the geographical coverage of EFSI operations also needs, in some cases, a correlated enlargement of the scope of the general objectives eligible for EFSI support (Council of the EU and European Parliament 2017, rec. 16). Thus, the implicit regional cohesion dimension of EFSI predetermines the thematic scope of its interventions. Related to this point, it is rather impressive that an unequivocal mention to less developed and transition regions (European Commission 2014b, p. 22, Annexes I and II) is made in the Regulation on EFSI 2.0, specifically widening the scope of the general objectives of the EFSI for these regions to "other industry and services eligible for EIB support."[20] This is probably the point where the EFSI scheme presents the closest resemblance to the ESIF and the EU Cohesion Policy objectives.

The nature of the instrument as demand-driven and lacking geographical pre-allocation criteria for the distribution of investment capitals means that projects are considered based on their individual merits. Nevertheless, this creates some uncertainty: Why would an EU member state want to contribute to the initial funding

[20]Regulation (EU) 2017/2396, Article 1(a)(v) adding Point (h) to Article 9 Paragraph 2 of Regulation (EU) 2015/1017.

of the EFSI if it is not preliminarily sure that it will gain some profit out of the investments increase on its territory? Herein lies a serious problem that has to do with the structure and underlying philosophy of the IPE. This Plan brings forward a new mechanism that has the ambition of transcending the intergovernmental character of the EU budget and the "*juste retour*" ("just returns") rule (Elgström and Jönsson 2005), according to which member states are divided into "net donors" and "net receivers," depending on whether they receive less than they contribute to the EU budget or vice versa. But the problem is the following: If the IPE is to be a genuine community, quasi-federal mechanism transcending intergovernmental competition and a hidden neo-mercantilist protectionism that we can find today in some big member states of the EU (Papadopoulos 2013), it will logically have to increase its funding basis from the EU budget itself so as to reduce the importance of national contributions to funding sources that are complementary to European ones. Otherwise, if the ratio "European funding to total capital contribution" is not high enough, then this new and ambitious financing mechanism is in danger of being drawn into the tug of war between national economic interests.

## 6 Conclusion: An Air of Financial Ease in a Universe of Fiscal Restraint

The disinvestment aspect of the European crisis was quite dramatic, since the overall level of investment in the EU dropped during the financial crisis by about 15% since its peak in 2007 (European Commission 2014a). However, the EFSI is not designed as a classical Keynesian fiscal stimulus, but is expected instead to act as "a catalyst for private finance by addressing market failures so as to ensure the most effective and strategic use of public money" (Council of the EU and European Parliament 2015, rec. 23). That means that the idea itself of deficit spending temporarily exempted from the upper limit of the Stability and Growth Pact (hereinafter SGP) is excluded, even though the new public expenditure could be obligatorily channeled to capital spending and not to public consumption, otherwise said, the public sector could accrue deficits only to the extent they are spent for public investment (a practice widely known as "the golden rule").

This self-imposed restriction is really economically irrational, since the EIB is fully capable of discerning public expenditure that combines growth-enhancing characteristics in the long run with high multiplier effects in the short run and with an important European added value of financed projects, on the basis of the priorities given by the member states' governments themselves. Therefore, it can approve increases in public spending in those strictly predefined categories (IMF 2014).

Moreover, the European Commission, seconded by the expertise of an independent authority such as the European Court of Auditors, could certainly monitor and assess the adherence of the projects to the aforesaid ground rules, and could also attach conditionality clauses concerning structural reforms as a prerequisite to

funding by the Investment Plan. This proposal, based on a paper by Karl Aiginger and Jürgen Janger where they expound their "silver bullet proposal" (Aiginger and Janger 2015), does not necessarily imply a Treaty change (even though this would be commendable), but can make use of all the margin of flexibility already provided for in the Fiscal Compact and in the legislation implementing the SGP. Such a temporary and intelligent fiscal stimulus, combined with a risk-enhancing mechanism for the attraction of private capitals, as is the EFSI, and with structural reforms on the supply side, could indeed have given a real boost to the anemic European economy.

The IPE is based instead on a strategy of risk-sharing via the use of public funds and guarantees so as to ensure financial viability and, most importantly, mobilization of private financing. This strategy is very different from the EU approach of achieving growth through the subsidization of operational programs, as is notably the case for the big bulk of the ESIF. Even if we omit, for political reasons, a more growth-friendly restructuring of the EU fiscal policy framework in favor of a clearly pronounced "golden rule," we still could imagine some more modest conditions under which this strategy could be crowned with success. A European Political Strategy Centre (EPSC) strategic note (EPSC 2016) outlines a sectoral extension of EFSI via: (a) the creation of a dedicated Venture Capital Window providing pooled finance for investment, (b) the deployment of Social Innovation financial instruments, together with social impact indicators, so as to pool private resources and channel them into social enterprises (ETUC 2014; Caimi 2016; EASPD 2015), (c) the creation of a dedicated Human Capital Investment instrument providing pooled finance for training, life-long learning in SMEs, apprenticeships, and internships, and even (d) a bundling of Bank Non-Performing Loans with an EU guarantee, so as to enable securitization and on-selling of these loans and to cleanse up week banks' balance sheets. An increase of the EFSI size and its eventual transformation into a permanent structure are the logical offshoots of such a project.

In any case, a fundamental problem to be resolved is that, since the EFSI is demand-driven, the amount of projects financed in a country will ultimately depend on the existence of potential investors willing to invest in it, and this, in turn, will depend to a large extent on the country's political and economic certainty, its administrative capacity, the level of its know-how in the use of market-based instruments, and the strength and expertise of its NPB (Pellerin-Carlin et al. 2016, pp. 42–43, 49–50). In this regard, the EIAH can certainly play a crucial role as a single access point for investment support and a coordinator of a network of national promotional institutions, by providing special attention to those EU member states that are less capable of structuring high-risk projects and of using financial instruments and that lack a strong National Promotional Bank. By reinforcing cooperation between the EIAH and the NPBs via sharing of best practices and exchange of staff, and by using a national EIAH office as the entry point for EIAH's potential beneficiaries and promotional actions, the IPE can reduce the difference between weaker and stronger member states as to the identification and development of high-quality projects (Pellerin-Carlin et al. 2016, p. 54, 74–76; EPSC 2016, p. 3). Furthermore, the EIAH could provide guidance and technical support to national managing authorities so as for them to maximize the potential for a combination of

ESIF and EFSI funds, notably by establishing "layered funds" that will help EU member states lagging in an administrative capacity to attract private investment in areas and sectors where they would not have invested otherwise (Pellerin-Carlin et al. 2016, p. 79–80).

Finally, the European Commission has a key role to play under the IPE in overcoming national and regional gaps in transparent and long-term public project pipelines (Pellerin-Carlin et al. 2016, p. 82). A serious structural problem for several member states is that of depoliticizing project selection so as to avoid the entrapment of valuable resources in "white elephants," i.e., very expensive and visible, but of dubious added value, public projects. If the European Commission establishes some guidelines to ensure that national and regional project proposals for EFSI financing translate long-term infrastructure needs and investment priorities, and obey to a set of economic, social and environmental criteria reducing the risk of favoritism or corruption, the IPE will have served as a catalyst for a major structural reform across the EU.[21]

The above proposals might seem overly ambitious for the cautious fiscal policies adopted by the EU and might need to be postponed until after a new negative demand shock of vast proportions erupts. In the meantime, the operation of the EFSI has clearly shown its potential, albeit at a more modest level, since it has (in the words of the European Commission's in-house think tank) "reinforced and accelerated a process of cultural change in the EIB," in the sense that "from an institution designed to finance a (relatively) small number of large projects with little risk, it became one that finances a much larger number of relatively small and riskier projects" (EPSC 2016, p. 4; Pianta 2016). The changes in its governance scheme, the enhancement of its additionality element, and the wider geographical spread of its operations around Europe, which have urged the European Institutions to move toward an EFSI 2.0, are surely related to a deepening both of financial sophistication in the EU and of European financial integration (EPSC 2016), since "as a pan-European investment vehicle combining public and private money, [the IPE] can play the role of catalyst by financing cross border investments" (Berg et al. 2015, p. 19).

The EFSI has been successful up to now to crowd in significant additional finance from private and public investors, and has been particularly successful in ensuring more financing for SMEs (European Commission 2016g, p. 8). It has validated the flexibility built in the EU Multiannual Financial Framework (hereinafter MFF), since it has unambiguously shown the important leveraging capacity of an increased use of financial engineering in a constrained fiscal environment characterizing the MFF (European Commission 2016f; European Commission 2016h). In that sense, EFSI 2.0 has provided a non-negligible amount of legitimacy to the EU structural pattern

[21]The need to devise criteria of environmental sustainability, especially in the energy and transport sectors, for investment selection by the EFSI is pointed out by a joint NGO report of October 2016 (Counterbalance et al. 2016); see also recommendations for both the EFSI and the EIAH so as to facilitate increased public–private climate-related investment and thus to move faster toward a green transition in Bowman (2017).

"Fiscal restraint/Financial ease," and has therefore lessened the sense of urgency of an EU economic policy overhaul.

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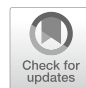
# Foreign Direct Investment and Growth Causality in the EU Countries and in the Transition Economies




**Nikolaos Apostolopoulos, Zacharias Dermatis, and Panagiotis Liargovas**

**Abstract** This chapter investigates the impact of FDI on the GDP, in three groups of European countries; the European Union countries (EU-28), the Euro Area countries (EA-19), and the Eastern European Countries (EEC). An empirical model for this correlation was used to calculate the level of this correlation. The results reveal that FDI has a decisive impact on GDP, although it differs in each one of the previously mentioned groups of countries.

## 1 Introduction

Foreign Direct Investment (FDI henceforth) contributes to national growth and improves the macroeconomic performance of host countries. Indeed, FDI increases exports and profits, especially in developing countries. Moreover, the allocation of domestic investment is improved along with the promotion of job creation, improvement of technology transfer, and enhancement of the overall growth (Dritsaki and Stiakakis 2014). FDI is considered important in highly developed countries and more so in developing ones. It is argued that FDI not only provides direct financial resources but also creates ideal conditions by transferring technology and knowledge from technologically developed countries to economically developing countries. This can be achieved by linking multinational suppliers to local and through increased competition. Through these channels, future FDI can boost changing economic output, open up the world economy, and lead to faster economic integration with developed countries.

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Also, regional economic integration is considered as the driving force behind FDI in a country. The aim of this research is to evaluate the above relationships reflected in the positive relationship between FDI and economic growth, in terms of the increase of GDP. Furthermore, it aims to investigate the differences between the countries related to their level of development and economic integration. On the basis of the above, the degree of correlation of FDI to the rate of GDP change will be investigated. The data to be analyzed cover a long period of 30 years (1986–2016), from three different groups of countries: the European Union countries (EU-28), the Euro Area countries (EA-19), and the Eastern European countries (EEC). The three groups differ in the level of development and in the level of economic integration.

Our main aim is to draw conclusions from the results of an analysis that can be used to develop economic policy approaches that improve the impact of FDI on GDP. The outcome of this research can act as a navigator of helping countries to understand the impact of the FDI and apply relevant policies in attracting foreign direct investments toward enhancing their national growth.

The next section of the chapter presents some stylized facts regarding FDI in Europe and discusses the current literature. Section 3 examines the correlation between FDI and growth while Sect. 4 proceeds with the empirical investigation. Section 5 presents the empirical results while the last section of the chapter offers some concluding remarks.

## 2 FDI in Europe: Current Literature and Stylized Facts

Foreign Direct Investment corresponds to the investment in an affiliate in a country different than the country in which the investing firm, the parent firm, is based. FDI involves the transfer of various production resources from the parent company to its affiliate, such as capital, equipment, raw materials, know-how, and organizational skills. The parent company controls the affiliate created through FDI, usually by holding a certain percentage of the latter's equity and affects the affiliate's decision-making process and criteria in selecting technology, raw materials, etc. Actually, FDI entails the creation of a continuous and long-term interest and effective management control of the affiliate in another country.

Thus, FDIs are usually made in open economies that offer skilled labor and higher growth prospects for the investor. The key factor of an FDI is that it creates effective control and influence on the decision-making of the affiliate.

According to the United Nations (UNCTAD 2007), an FDI is defined as "an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate). FDI implies that the investor exerts a significant degree of influence on the management of the enterprise resident in the other economy. Such investment involves both the initial transaction between the two entities and all subsequent transactions between them

and among foreign affiliates, both incorporated and unincorporated. FDI may be undertaken by individuals as well as business entities."

An FDI has the following three main components, according to UNCTAD (2007): (1) equity capital, (2) reinvested earnings, (3) intra-company loans or intra-company debt transactions. The firms that undertake FDIs are commonly referred to as multinational firms, multinational enterprises, multinational corporations, or transnational corporations, while the forms of FDIs are: (1) *Horizontal FDIs*, where the parent firm undertakes in the host country the same type of production activity as the one it undertakes in its home country; (2) *Vertical FDIs*, where the parent firm undertakes in the host country complementary activities; and (3) *Conglomerate FDIs*, where the parent firm undertakes different production activities in the host country which are not related to its actual activities in the home country.

There are also many other classifications of FDIs, such as those by Moosa (2002), classifying FDIs on the basis of their impact on the host country's balance of payments as: (1) *Import-substituting FDI*, through which local production substitutes imports of goods by the host country and (2) *Export-increasing FDI*, through which the affiliate produces in the host country intermediate products exported to the home country. Moreover, there are classifications according to the specific advantages of the FDIs such as (Dunning and Lundan 1993, 2008; Buckley and Casson 1985): (1) *Efficiency-seeking FDl*, where the parent firm's motive is to exploit its advantages in various institutional and economic contexts by undertaking activities in different locations, and thus, by operating in *MNC* aims at obtaining strategic assets (tangible or intangible) crucial to the MNC's sustainability and (2) *Political safety-seeking FDl*, where the parent firm pursues to establish new business in countries that are considered politically stable.

Figure 1 shows FDI in net inflows (BoP, current US$) in EU-28, EA-19, and EEC from the available data from the World Bank (2019) for the period of time 1970–2018, while Figs. 2 and 3 show the GDP (current US$) and GDP Growth (%) for these countries and for the same period of time.

Theoretically, it is suggested that FDI increases GDP through the accumulation of capital and the incorporation of new foreign inputs and technologies leading to greater productivity and profitability, although the benefits frequently reported by FDI, such as technology transfers and management know-how, tend to be related to the manufacturing sector rather than the agricultural or mining sector (Findlay 1978). Obviously, in the absence of connections, the impact of FDI is lower than the expected one on the national economy.

The *relationship between FDI* and economic growth is described by and can be identified in economies all over the world (Chenery and Strout 1966). However empirical evidence is not clear for the direction of the causal interrelation between FDI and economic growth (Kholdy 1995). Undeniably, this is a two-way relationship as GDP can impact on FDI and vice versa.

Thus, FDIs and economic growth are interrelated. The high rate of economic growth attracts more foreign direct investments and in the same time FDI, due to the secondary effect, provides the country with an even higher rate of economic growth

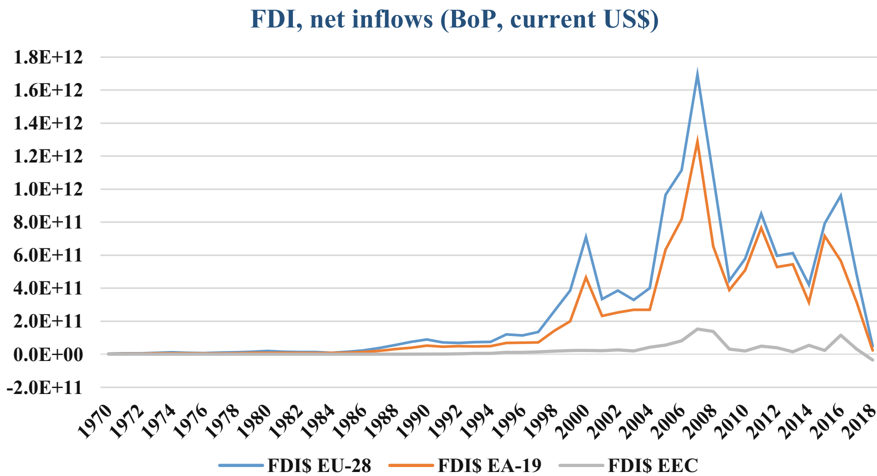


**Fig. 1** FDI, net inflows (BoP, current US$) in EU-28, EA-19, and EEC (Source: World Bank 2019)

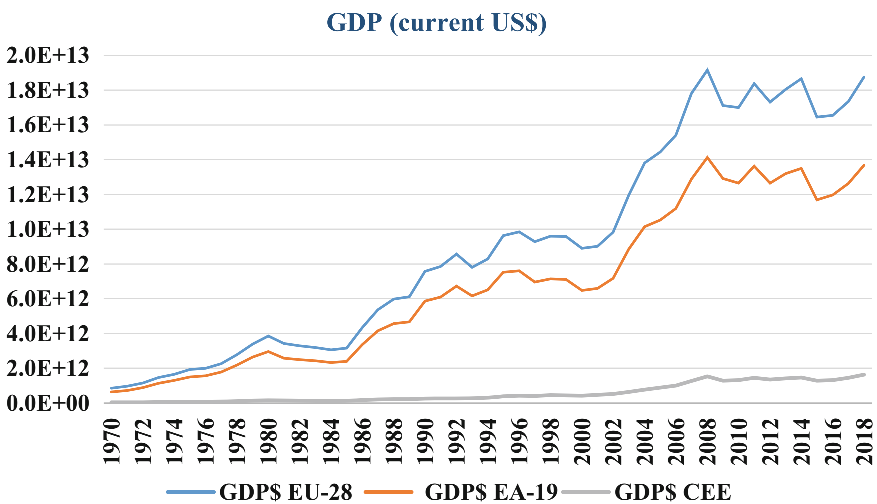


**Fig. 2** GDP (current US$) in EU-28, EA-19, and EEC (Source: World Bank 2019)

(De Mello 1999; Hansen and Rand 2006; Ghatak and Halicioglu 2007). In addition, recent studies reveal that both FDI inflows and exports promote high rates of economic growth (Sunde 2017; Abdul et al. 2017). Finally, there are studies challenging the importance of FDI as there is no correlation whatsoever (Carbonell and Werner 2018). Similarly, in the non-OECD countries, some authors (Borensztein et al. 1998; De Mello 1999) found that there was a significant impact of the FDIs on the rate of economic growth.

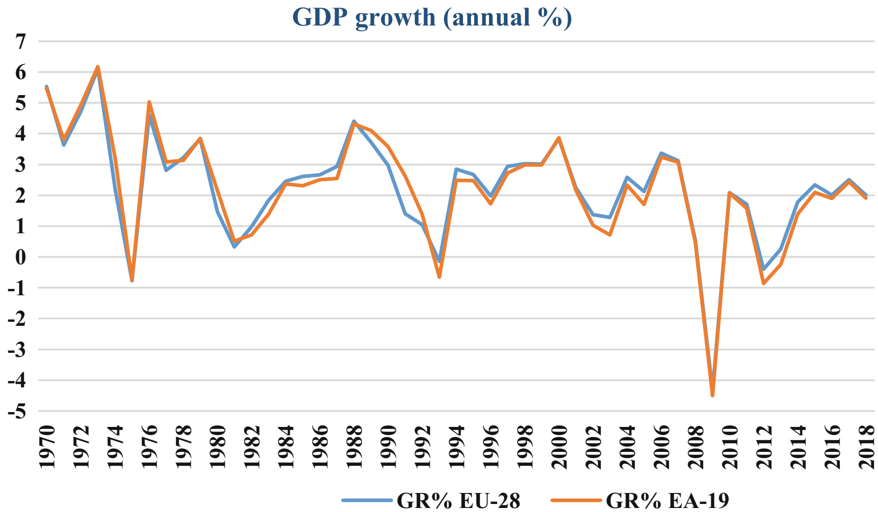


**Fig. 3** GDP growth (annual %) in EU-28, EA-19, and EEC (Source: World Bank 2019)

Also, the role of FDI as the major source of inflows to developing countries over the years has been examined by some authors who report their significant contribution to these countries (Falki 2009). Moreover, FDI has a significant contribution in accelerating growth and economic transformation in developing countries (UNCTAD 1998).

As far as the determinants of FDI locations are concerned, they may vary according to the location or the type of investment. Some authors believe that location plays a very important role (Erbe 1970; Branson and Hill 1971; Bayar and Ozel 2014; Enisan 2017). Some others (Bevan et al. 2005) found that the structure of the labor market and its characteristics are important parameters of the FDI effectiveness. Again, some of them (Farrell et al. 2004) found that market size is the key factor for FDIs.

Economic prosperity along with the level of liberalization of the capital markets seem to be the determinants for effective FDIs (Bengoa and Sanchez-Robles 2003). In addition to that, political stability and inflation contribute decisively to FDI, especially in OECD countries (Pourshahabi et al. 2011).

Additionally, there are findings (Saini and Singhania 2018) showing that GDP growth and trade openness can support developed countries in attracting investments, while in developing countries, crucial determinants are the gross fixed capital formation and the efficiency parameters.

## 3 Correlation Between FDI and GDP

Our hypothesis is built upon the assumption that the average value of GDP ($GDP_{av}$) for a specific time period, for the countries of each one of the three groups studied (EU-28, EA-19, and EEC) is related to the average value of FDI ($FDI_{av}$) for this time period and for the countries of each one of the same groups of countries, as follows:

$$``(GDP_{av}) = b\ (FDI_{av})^{a}" \tag{1}$$

i.e.,

$$``\ln(GDP_{av}) = a\ \ln(FDI_{av}) + \beta" \tag{2}$$

where:

$$``\beta = \ln(b)" \tag{3}$$

Equation 2 was used to confirm our hypothesis, and the average values of GDP and FDI for European countries belonging to the previously mentioned three groups of European countries.

The results of linear regression for the period between 2002 and 2018, using the available data from the World Bank (2019), for these countries, belonging to these three groups, are shown in the diagrams of Figs. 4, 5, and 6. The figures provided

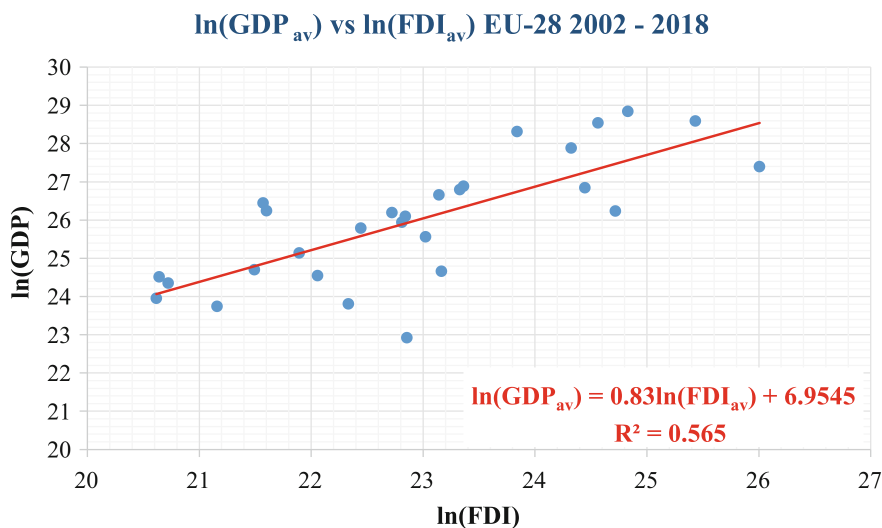


**Fig. 4** Diagrams of $\ln(GDP_{av})$ vs. $\ln(FDI_{av})$ for EU-28 for years 2002–2018 (Source: Authors calculations)

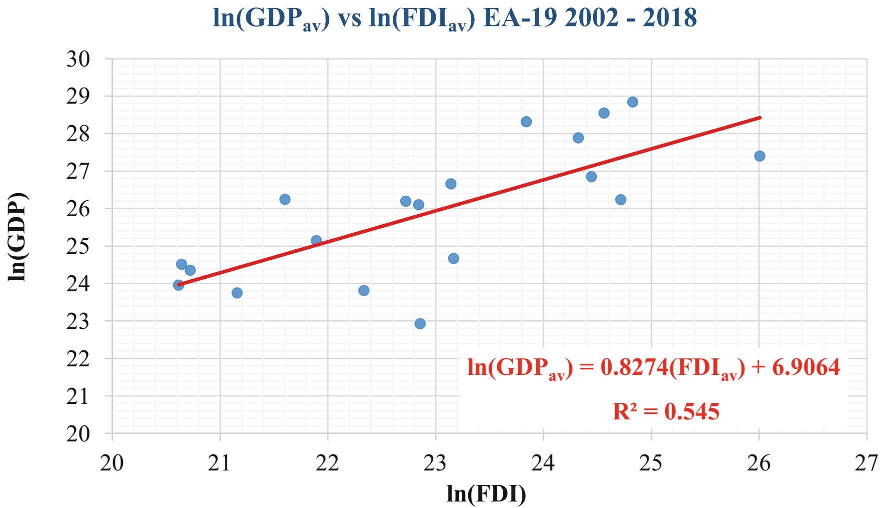


**Fig. 5** Diagrams of $\ln(GDP_{av})$ vs. $\ln(FDI_{av})$ for EA-19 for years 2002–2018 (Source: Author's calculations)

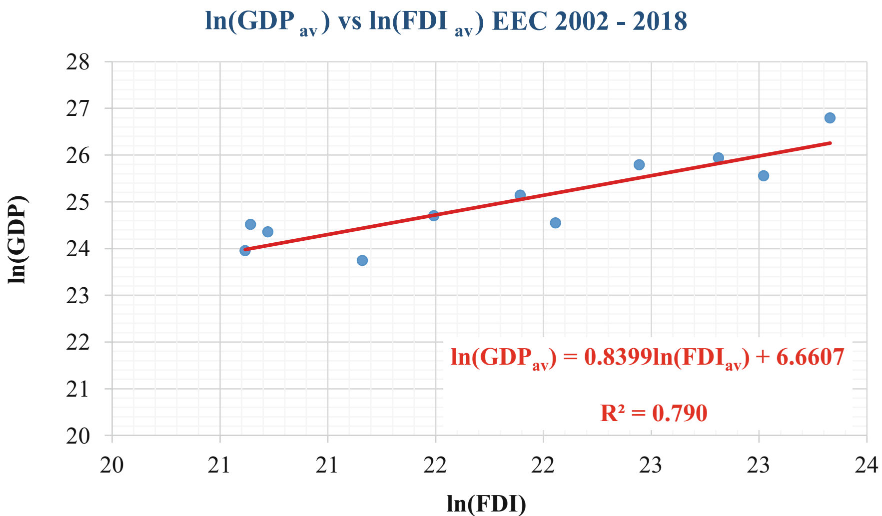


**Fig. 6** Diagrams of $\ln(GDP_{av})$ vs. $\ln(FDI_{av})$ for EEC for years 2002–2018 (Source: Author's calculations)

show the relations of $\ln(GDP_{av})$ versus $\ln(FDI_{av})$ in EU-28, EA-19, and EEC countries for years 2002–2018.

Also, the used data from the World Bank (2019), followed by the obtained results of linear regression, confirm our hypothesis.

Exponent α has similar values for all cases (0.830 for EU-28, 0.827 for EU-19, and 0.840 for EEC), with statistical significance, while constant $\beta = \ln(b)$ has also similar values (6.9545 for EU-28, 6.9064 for EA-19, and 6.6607 for EEC).

## 4 FDI and Growth in the EU: Discussing the Results

The findings of this study are consistent with other investigations related to the impact of the FDI on the GDP. Hines and Rice (1994), Loree and Guisinger (1995), Cassou (1997) and Kemsley (1998) revealed that a country, in its effort to attract foreign direct investments, has to deal with parameters such as corporate income taxes and, as a consequence, in these cases, the outcome of the FDI might not be the expected one. Indeed, taxes can have a negative impact on investments especially in countries trying to cope with an economic crisis and when the austerity measures force them to apply high taxation (Liargovas and Apostolopoulos 2017). Other studies, such as the one conducted by Angelopoulou and Liargovas (2014), concluded that trade openness, as a parameter, does not influence FDI, and a major parameter which impacts the effectiveness and success of foreign direct investments is the economic stability. Confirming the importance of trade openness, Asteriou and Spanos (2019) underpinned that trade openness is a crucial determinant of the economic growth in the EU. Moreover, Pegkas (2015) applied a panel data analysis to Eurozone countries revealing that the stock of foreign direct investments contributes to economic growth in the Eurozone.

Furthermore, Campos and Kinoshita (2002) mentioned that FDIs can play an important role in economic growth and this is consistent with our analysis. To this extent, Bruno and Cipollina (2018) reviewed a meta-regression analysis based on 52 studies and they concluded on the indirect effect of FDI to the productivity and the difference in attracting foreign direct investments due to the internal environment of each country. With that said, the economic context and the conditions of each EU country have an impact on attracting foreign direct investment (Albulescu and Ionescu 2018). In addition, Borensztein et al. (1998) support GDP indirectly as the technological transfer through the FDI presents long-term positive benefits and at the same time, De Mello (1999), supports these findings, especially for developing countries. On the other hand, our findings do not provide a clear picture of whether they can support the studies conducted by Carkovic and Levine (2005), and Blonigen and Wang (2004) in developed countries. In addition to that, as Stanisic (2015) mentions, the EU countries with transition economies do not present a positive impact caused by foreign direct investments.

## 5 Conclusions

This research investigated the interrelation between FDIs and economic growth as expressed through the GDP. The regression analysis confirms our hypothesis of the positive impact of FDIs on the three groups of European countries studied; the European Union countries (EU-28), the Euro Area countries (EA-19), and the Eastern European Countries (EEC). The results reveal that FDI has a decisive impact on GDP, although there are small differences in each one of the previously mentioned groups of countries. The examined time period spanned between 2002 and 2018, providing this study with a sufficient time period of a secure analysis.

This study recognizes that the hypothesis set has been analyzed in previous studies with more advanced statistical approaches, e.g., panel data analysis. However, the aim is to validate the relationship between FDI and economic growth by using the most recent available data in a simple way in order to be accessible to both academics and policy makers. To this extent, through the lens of validating the hypothesis with the most recent data, this study contributes to our existing knowledge. With that said, examining the impact of foreign direct investments in the EU has to be carefully analyzed and depends on the lens of which the research is conducted through. For example, the study of Delevic and Heim (2017) highlights that further European integration might not lead to an increase in foreign direct investments.

Finally, the outcome of this study can act as a policy navigator and underpin the importance of building relevant FDI-friendly policies for both inflows and exports. It would be significant in terms of research if this approach was to be used in countries suffering from economic crises and external shocks by separating the time period before and after the crises. Moreover, as regional governments have gained more power over the last years in the EU (Liargovas and Apostolopoulos, 2014), future studies should explore how foreign direct investments are influenced by regional factors or how regions can attract foreign direct investments.

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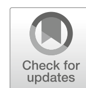
# Part III
# Country Specific Analyses on Foreign Direct Investment and Economic Growth

# FDI to and from the Russian Federation: A Case Study of the Western Balkans and the Role of the EU




**Iulia N. Sushkova and Antonia Koumpoti**

**Abstract** The present contribution discusses foreign direct investments in the Russian Federation, mainly after the imposition of the western sanctions, the state of play of the European sanctions, and uses the Western Balkan countries as a case study of Russian and European influence in their economic sectors. Furthermore, it investigates the immediate measures the Russian Federation took in transferring key aspects of the national industry to its domestic producers. At the second part of the chapter, the situation in the Western Balkan countries is discussed, as the soft power the Russian Federation projects in the region is based on influence and economic ties while the EU projects its membership perspective, its power of attraction, and the dual advantage it possesses as investments are made both from the EU as a *sui generis* international organization but from its member states as well. Nonetheless, the investment policy of Russia by focusing on strategic sectors is promoting its international stance making its foreign economic policy of great importance in ensuring the country's global leading position.

## 1 Introduction

Generally, Foreign Direct Investment (FDI henceforth) is defined as an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate) (IMF 1993; OECD 1996). FDI implies that the investor exerts a significant degree of influence on the management of the enterprise resident in the other economy. Such investment involves both the initial transaction between the two entities and all subsequent transactions between

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them and among foreign affiliates, both incorporated and unincorporated (UNCTAD 2007).

The main task of foreign investment is not only to provide additional financial investment in the economy but also to meet the needs of the recipient country in new progressive working methods and means of production. Consequently, FDI meets different needs for different countries and serves different interests for different investors. At the same time, new production relations form in the recipient country, which allow for more efficient use of available foreign capital. Concerning the Russian case, increased foreign investment is not only the basis of the recovery process but also a factor of the reduction of unemployment, growth of tax revenues, raise in the level of the Russian management, increased competition in the national economy, and social development (Kryukova et al. 2014; Zaernjuk et al. 2014).

More specifically and concerning the conditions for attracting foreign investors to the economy of the Russian Federation, the guarantees of their rights are regulated according to the Federal Law on Foreign Investments № 160. Federal laws on banking and insurance regulate the relations connected to foreign capital investment in Russian banks, credit and insurance companies. Meanwhile, according to the Decree of the Russian government № 87 (2017), transactions of foreign investors with strategic importance for the national defense and security are coordinated by the Ministry of defense.

FDI to the Russian Federation has significantly fluctuated over the years. Recent international developments, as is the global financial crisis, the annexation of Crimea, and the Kerch Strait incident, have affected the inflow of investments in the country. One reason for this decrease in FDI is the sanctions imposed by the EU which led to countersanctions by the Russian Federation and how they affected both inward and outward FDI to and from the Russian Federation.

The present contribution begins with a literature review regarding FDI and continues in discussing factors affecting FDI in the case of the Russian Federation as an economy in transition, the course of FDI over the last years, the offshoring effect, and the introduction of an import substitution model. The Sect. 4 discusses the European sanctions imposed on the Russian Federation introducing, and in the Sect. 5, the connection to the Western Balkan countries by analyzing similarities and ties between them and the Russian Federation and the EU and the state of play in economic terms. Lastly, conclusions are drawn based on the analysis.

## 2 Literature Review

There are many factors that could have an impact on and affect positively or negatively the FDI flow value. These factors can be separated into three large groups: the economic, the institutional, and the similarity factors. The first group is associated with economic factors like the openness of the country importing FDI (Kristjansdottir 2004; Talamo 2003), the inflation rate (Liebrecht and Riedl 2012), the government expenditures level (Azeem et al. 2012), the labor costs (Liebrecht

and Riedl 2012), the external trade level (Çevis and Çamurdan 2007), the taxes (Folfas 2011), etc. The second group represents institutional factors as is the political stability level (Sova et al. 2009), the corruption level (Kayam and Hisarciklilar 2009), the R&D level in a country (Bormann et al. 2005), and the investors' protection level (Pagano and Volpin 2005). The third group deals with indicators that characterize the similarity between two countries as is the common language (Folfas 2011), the common border (Africano and Magalhaes 2005), and the common historical features (Africano and Magalhaes 2005).

Moreover, researchers have identified the following factors as significant in affecting the Russian economy: level of infrastructure development (Broadman and Recanatini 2001; Iwasaki and Suganuma 2005), location of a port in the region (Castiglione et al. 2012; Ledyaeva 2007), trade openness (Yukhanaev et al. 2014), resource endowment (Iwasaki and Suganuma 2005; Ledyaeva and Linden 2006), crime level (Brock 1998), social development level (Castiglione et al. 2012), and agglomeration factors (Iwasaki and Suganuma 2005; Ledyaeva and Linden 2006; Ledyaeva 2007). Some Western-European researchers consider the financial crisis of 1998 as the turning point for the level of FDI inflows in Russia. Broadman and Recanatini (2001) suggest the existence of a postcrisis downshift in FDI, while Iwasaki and Suganuma (2005) reject this.

Komendantova et al. (2016) argue about the importance of understanding human factors, such as risk perceptions, and their impacts on decision-making processes regarding FDI and subjective factors. There is a difference between existing risks, such as changing institutional environment, and perceived risks, which can be subjects of cognitive and behavioral biases. Evidence also exists that the significant positive effects FDI offers to the Russian economy were less significant in other countries of the region. For instance, Iwasaki and Tokunaga (2014) discuss the significant positive effects of FDI on total factor productivity in the Russian regions and the remarkable role of FDI in the country's regional economic development. However, Azam and Ahmed (2015) found weak statistical evidence of positive effects of FDI on economic growth of other countries of the region, not only because these countries were not able to attract desirable volumes of FDI but also due to uncertainties and economic disturbances in the last years.

## 3 Foreign Direct Investments in the Russian Economy

The Russian Federation possesses vast natural resources, a large consumer market, a highly educated workforce, and advanced scientific and technological capabilities which are, at large, the criteria a country should meet for attracting FDI. The modern Russian economy has great potential for development, but development cannot be achieved without investments. Attracting foreign investors is a strategic task of great importance for the Russian government (Azatyan and Dudakova 2016). For the Russian Government, in order to attract foreign investments, it is necessary to create conditions of a favorable investment environment, develop free economic zones, and

improve infrastructure in the regions of the country. Political, economic, and financial conditions must be improved to increase investment. In that way, FDI in the economy will allow for: the attraction of capital and technology, the acceleration of GDP growth and the modernization of production, the increase of the competitiveness of domestic products in the world market in the context of globalization, the acceleration of the process of export diversification, the increase of productivity and the improvement of the organization of production, and the reduction of the level of accidents at industrial facilities (World Bank 2011).

More specifically, the investment activities are specifically coordinated by the Investment Policy Department of the Ministry of Economy. In order to improve the investment climate in Russia the Foreign Investments Advisory Council (FIAC) was established in 1994 aiming to assist in forging and promoting a favorable investment climate based on global expertise and the experience of international companies operating in Russia (FIAC, n.d.) and by 2009 new tasks and principles were established. The Council is chaired by the Russian Prime Minister and includes 53 international companies and banks,[1] while several working groups were established throughout the years.

## *3.1 The Russian Federation as an Economy in Transition*

The countries in transition are attractive for investors due to their favorable geopolitical location, strong positions on big markets, macroeconomic and financial stability, and because of low taxes and low labor costs for a skilled labor force. That is why advertising the country's potential for economic development is a key component for successfully attracting funds. And the successful attraction of funds in the form of FDI is a key factor for improving economies (Joksimovic et al. 2019).

Generally, the effects of FDI on economic growth in transition economies were tested by Campos and Kinoshita (2002), who found significant positive effects. However, this effect will depend on the quality of the institutional framework in the hosting transition countries (Jude and Levieuge 2017).

Russia is considered a transition country, changing from a centrally planned economy to a market one (Feige 1994). But despite that, FDI flows to economies

[1]These companies are 3M Company, ABB Ltd., Abbott Laboratories, Arconic Inc., AstraZeneca, BASF SE, Bayer AG, BP, BAT, Cargill, Inc., Carlsberg Breweries A/S, Danone, Deutsche Bank AG, ENEL S.p.A., Equinor ASA, Essity Aktiebolag (publ), EY, Exxon Mobil Corporation, Fortum Corporation, Henkel AG & Co. KGaA, IKEA Group, International Paper, Kinross Gold Corporation, LafargeHolcim, Mars, Incorporated, METRO AG, Mitsubishi Corporation, Mitsui & Co., Ltd., Mondelez International, Inc., Nestle S.A., Novartis AG, Olam International Limited, PepsiCo, The Procter & Gamble Company, Repsol, ROCKWOOL International A/S, Royal Dutch Shell plc., Saint-Gobain, Samsung Electronics Co., Ltd., SANOFI, Schneider Electric, Siemens AG, Société Générale Group, SOLVAY Group, SUN Group, Takeda Pharmaceutical Company Limited, Tetra Pak, The Coca-Cola Company, Total S.A., UniCredit, Unilever, Uniper and The World Bank.

in transition continued their downward trend in 2018, declining by 28% to $34 billion, driven by a 49% drop in flows to the Russian Federation (UNCTAD 2019). The contraction was driven by a halving of flows to the Russian Federation, by far the biggest economy and largest FDI recipient in the group, from $26 billion to $13 billion (UNCTAD 2019, p. 19). At the same time, the Russian Federation accounts for the bulk of the outward FDI in this group (95%). The country's outflows rose by 7% to $36 billion, driven mainly by reinvested earnings and the extension of intracompany loans to established affiliates (UNCTAD 2019, p. 21).

Investors remained cautious, in part due to geopolitical concerns and sluggish GDP growth. Equity capital registered an unprecedented negative value (−$6 billion), due to both disinvestments (sales of foreign affiliates to Russian investors) (ILO 2018), and the de-offshoring of Multinational Enterprises (MNEs) of Russian origin. De-offshoring has been a policy aim of the Russian Government since 2012 (Kheyfets 2018) to counteract the strategies of some Russian firms to domicile their head office and/or part of their share capital in economies with sizeable corporate services industries, such as Cyprus, Ireland, and the Netherlands (See Sect. 3.3).

## *3.2 The Course of FDI in the Russian Federation*

Conversely, it can be said that the environment for foreign investors in the Russian Federation has greatly improved over the course of the last decade. More specifically and according to the Ease of Doing Business Ranking, the country, in 2010, took the 120th position out of 190 countries (World Bank 2010) and its ranking improved as it achieved the 40th place in 2017 (World Bank 2017), the 35th in 2018 (World Bank 2018), and the 31st place in 2019 (World Bank 2019). Also, several reforms were made concerning the protection of minority investors by requiring greater corporate transparency (World Bank 2019), the registration of property as the Russian Federation made it easier to transfer property by reducing the time needed to apply for state registration of title transfer and, finally, the access to credit by adopting a new law that establishes a modern collateral registry (World Bank 2018).[2]

More specifically, in 2008, FDI in the Russian Federation reached its peak with $74.783 billion been invested only to be followed by a substantial decrease in 2009 ($36.583 billion) and by 2013, FDI returned to somewhat normal levels with $69.219 billion being invested. Following the sanctions imposed by the United States of America and the European Union against the Russian Federation, FDI tanked with only $6.853 billion being invested in 2015, an amount that grew in the next 2 years ($32.539 in 2016 and $28.557 in 2017) and tanked again in 2018 with only $8.785 billion (For a more detailed picture of FDI inflow during these years see Fig. 1).

[2]All reforms apply to both Moscow and St. Petersburg.

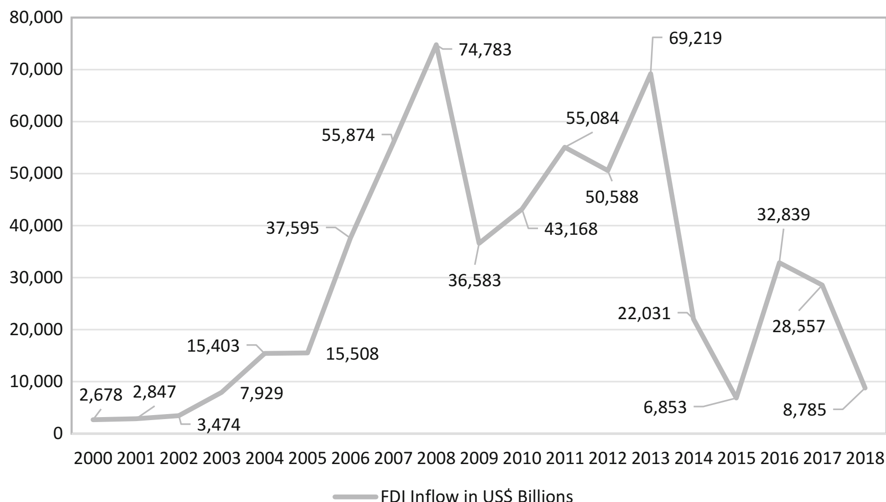


**Fig. 1** FDI inflow in the Russian Federation, 2000–2018 (Source: Data retrieved from World Bank statistics)

Already in 2008, Russia was ranked as the 6th country in the world in terms of attracting FDI and the 8th in terms of GDP (UNCTAD 2008). The global economic and financial crisis of 2008–2009 changed that situation having displaced Russia from the standpoint of the world's key recipient of foreign investment. The FDI growth resumed after the wave of the crisis placing Russia 3rd among the top twenty largest FDI recipients ($94 billion) after the United States ($159 billion) and China ($127 billion) (UNCTAD 2014).

Due to the deterioration of the investment climate in 2014, FDI in the Russian economy fell sharply. The sanctions adopted against the Russian Federation have led to the disappointment of investors and money began to move to other BRICS countries, such as India and Brazil, as well as to developed European capitals. More specifically, in the second half of 2014, the Bank of Russia reported an outflow of foreign direct investment, which fell down to $22 billion, the lowest record since 2006 (−$6.853 billion). In 2016, the volume of foreign direct investment amounted to $ 32.84 billion; however, the growth of foreign investments in 2016 was largely due to the purchase by an international consortium (Qatar and Switzerland) of 19.5% of "Rosneft" shares. That said, in November 2016, a mission of the International Monetary Fund (IMF) visited Russia and reported that the Russian economy showed signs of recovery (IMF, n.d.).

The changing international situation as well as the volatility of the energy prices became the main reason for the sharp decline in foreign direct investment in Russia since 2014 (Zaytsev 2016); however, not all sectors of the Russian economy were affected the same nor did they have the same decline due to government support measures. Moreover, one should not overlook the huge role round-trip investments

and the introduction of anti-offshoring legislation had on the fluctuation of FDI over the last decade.

### *3.3 The Russian Federation, FDI Offshoring, and Round-Trip Investments*

Research has identified the round-tripping of capital from emerging economies to offshore financial centers (OFCs) and back as FDI as a central element of the global offshore FDI network. Ledyaeva et al. (2015) argue that secrecy arbitrage, defined as interplay of onshore corruption and offshore secrecy, largely explains round-trip investment between onshore jurisdictions.

One key feature identified in the global offshore FDI network is that OFCs have a particularly strong position in both inward and outward FDI flows of emerging economies such as Russia (Haberly and Wojcik 2013). Therefore, most of the FDI in Russia from selected OFCs, such as Cyprus, could be money of Russian origin (de Souza 2008; Perez et al. 2012). Concerns have been raised by international organizations, such as the Organization for Economic Cooperation and Development (OECD) and the IMF, concerning the negative impact of round-tripping FDI on the image of emerging economies as FDI destinations and thus their ability to attract other FDI (Arun 2009; IMF 2004).

It can be said that there are three dimensions of OFCs, decisive for the round-tripping behavior: the regulatory dimension (represented by the provision of advanced financial/business services), the fiscal dimension (represented by low- or no-tax regimes), and the secrecy dimension (represented by the explicit secrecy and confidentiality rules) (Hampton 1996).

That said, round-trip investments are characterized by institutional arbitrage, a situation where a firm is able to exploit differences between two institutional environments. In the case of round-tripping, a firm originating from a country with an unfavorable institutional environment may move abroad to increase the firm's bargaining power when returning home as a foreign investor. This is because the firm is able to capture the same home country advantages in terms of legal and economic protections as other foreign investor firms (Boisot and Meyer 2008). At the same time, these investors are able to take advantage of the domestic favorable regulatory framework due to home market knowledge and networks (Sutherland et al. 2010) giving them an advantage over their foreign counterparts. In the end, Ledyaeva et al. (2015) explain this behavior as regulatory shopping, meaning the "gaining of access to more preferential regulation" (lower tax rules and favorable regulatory policies).

For those reasons, various amendments to the tax code of the Russian Federation have been adopted since the entry into force of the first anti-offshoring legislation on January 1, 2015, all of them rewarding the return of capital and making offshoring less attractive. In 2018, Federal Law No. 291-FZ created "inner offshore zones"

within the Kaliningrad Oblast and the Primorsk Territory—an attempt by authorities to establish an alternative to foreign offshore centers. These measures encouraged the repatriation of some Russian offshore capital in 2018, resulting in largely negative inflows from Cyprus and Ireland. Reinvested earnings by established foreign affiliates—historically the most stable component of inward FDI in the country—remained unchanged in 2018 (UNCTAD 2019, p. 71).

## *3.4 Import Substitution: Stimulating Domestic Production*

The sanction policy of the western countries directed against Russia motivated the Russian government to take immediate measures, transferring key aspects of the national industry to domestic producers. Despite the benefits of FDI in the Russian economy, especially in specific sectors, the aim was to implement the model of Import Substitution Industrialization (ISI), a trade and economic policy that advocates replacing foreign imports with domestic production (Brian 2009, p. 88). ISI is based on the premise that a country should attempt to reduce its foreign dependency through the local production of industrialized products. The goal of this policy was not to totally displace foreign producers but to firm domestic industries in order to strengthen Russia's economic sovereignty.

The issue of implementing the import substitution program in Russia has been on the agenda for a long time, since the share of imports had been and still remained high (Afonina and Prudius 2018). More specifically, the share of imports in the Russian industrial sectors was 50–90% in the agricultural production, up to 50% in heavy engineering, 80% in aircraft construction, and 60% in equipment for the oil and gas sector. This policy, affecting also sectors with a high presence of FDI was effectively undermining and worsening the relations between Russia, the United States, and the European Member States.

The economic sanctions have become a powerful impulse for strengthening the political and economic independence of Russia, spurring the development of industry and increasing its competitiveness. Based on introducing innovative technologies, improving the quality of products, and modernizing all sectors of the economy, import substitution at the present stage of the economic development of Russia contributes to the intensive transition to the production of high-tech products. Currently, 20 sectoral import substitution plans have been approved, covering 2200 technological areas of the domestic industry and defining measures to stimulate the participation of enterprises in the implementation of these programs (EICC 2016).

The main obstacle in the implementation of sectoral programs of import substitution was a sharp increase in prices for foreign components and consumables and still a high level of dependency on foreign technology (Rostec 2018). There are sectors of the economy where attracting foreign investment is crucial, especially in those sectors where Russia needs foreign technology and, therefore, there are areas in which import substitution programs are not implemented so quickly. In Russia,

there are regions-donors (self-sufficient) and regions-recipients. The state policy is aimed at attracting direct investments that contribute to the formation of large innovative industrial enterprises and technological clusters in these regions (Schankin and Kataikin 2012).

In order to better understand the reasons that motivated the Russian Federation toward an import substitution model it is wise to analyze the problems that the country was and is facing concerning the attraction of foreign direct investments. If the problems are deemed structural and therefore hard and time-consuming to change then this model was the appropriate solution.

## 4 Sanctions Against Russia and Russia's Response

As it was discussed in the previous section, FDI in the Russian Federation decreased substantially after 2014. One of the reasons for this downturn were the sanctions imposed by the EU and the United States. These measures include sanctions against blocking of assets subject to U.S. jurisdiction, limits on access to the U.S. financial system, including limiting or prohibiting transactions involving U.S. individuals and businesses, and denial of entry into the United States. The U.S. also tightly controls exports to Russia's energy and defense sectors (Congressional Research Service 2019).

The EU has three different sanction packages addressing distinct aspects. The first sanction package is a response to the destabilization of Eastern Ukraine and includes the suspension of high-level contacts and the blacklisting of individuals and entities (Council Regulation (EU) No 269/2014, Council Regulation (EU) No 692/2014 of June 23, 2014). Since the summer of 2014, it also entails restrictions of access to the EU's capital markets for certain Russian banks and companies, an arms embargo, and limits of access to some technologies and services for oil production and exploration (Council Regulation (EU) No 833/2014 of July 31, 2014). The lifting of this sanction regime was later linked to the full implementation of the accord that was reached in the context of the mediation talks held in Minsk, or the Minsk Protocol and the Minsk II Protocol. The other two packages of sanctions include an economic embargo on Crimea and the freezing of assets following the situation in the Kerch in November 2018.[3]

### *4.1 The State of Play of the European Sanctions*

While there is a long tradition of sanctions in EU foreign policy, most sanction measures wielded in the past have not been economic in nature (Portela 2010). The

[3]The measures now apply to a total of 170 persons and 44 entities.

combination of both elements in a single sanction regime—that of imposing measures with economic implications, and wielding them on a powerful neighbor—would have seemed improbable just a few years ago. And the fact that the EU has been able to sustain a rather unusual sanction regime for as long as 5 years, despite the reticence voiced by some of its members, would have seemed even less likely to observers (Portela 2019).

It is often claimed that the sanctions have failed because they have not brought any significant changes in Russian policy, or that Russia's economy has shown its resilience to external economic pressure and has not collapsed. It can be argued that the purpose of the sanctions is often misunderstood, this purpose has never been to bring the Russian economy to a total collapse but instead to target specific areas (Christie 2016). From the Western-European point of view and according to Council Regulation 833/2014, sanctions were meant to decrease the Russian involvement in the territorial integrity of Ukraine and to promote a peaceful settlement of the crisis (Council Regulation No 833/2014).

While EU member states have sustained the measures that were adopted in 2014, they seem unprepared to escalate them (Portela 2019). Meanwhile, there are signs that the transatlantic convergence on sanctions has reached its limits. Most recently, the American Congress adopted new sanction legislation which threatens to affect the involvement of EU Member States in energy projects with Russia (Lohmann and Westphal 2019) making the EU even more reluctant to replicate them.

Moscow did not stay still in the face of those sanctions and responded to the EU sanctions against the country's economic sectors. In accordance with the Russian President's Decree of August 6, 2014 (Decree of the President of the Russian Federation No. 560 of August 6, 2014), the Russian Government introduced economic countersanctions aimed to provide national security (Government of the Russian Federation 2014).[4] Russia's countersanctions included the banning of imported agricultural products, raw materials, and food from countries that had introduced measures against Russia. Thus, European agricultural exports totaling 11.8 billion euros to Russia stopped.

It seems rather strange but, in a wider context, EU sanctions against Russia have always stood behind the EU–Russia relations. Of course, EU's antidumping sanctions and sanctions within the framework of the EU competition policy are impossible to compare with the recently adopted restrictive measures pursuant to Article 29 of the TEU and Article 215 of the TFEU. However, despite the more negative impact on the economies of the parties, the sanctions have not crushed the EU–Russia balanced relations in the main sectors of economic interconnections, e.g., energy supplies, investments in industry, or trade in manufactured goods (Kalinichenko 2017).

Bearing that in mind, it is useful to investigate a specific region, that of Western Balkans, an area where both the Russian Federation and the EU are involved and

[4]However, the Russian Government mitigated the sanction later.

both aspire to be involved in as a case study of the state of play, of influence, power and future prospects looking at the economic aspect of their relations.

## 5 Western Balkans, FDI, and Transition Economies

FDI in the Western Balkan countries was negligible until 1990. The development of transition, and with it, the development of the privatization process created new opportunities for foreign capital owners which resulted in an increase of FDI into the region from that point on (Stanisic 2008). There is said to be a "Balkans" effect on FDI, meaning that only the mention of the word "Balkan" "conjures up troubled images of war and conflict, rather than investment opportunities and economic potential" (Cviic and Sanfey 2010, p. 124). This effect is also confirmed by Estrin and Uvalic (2014) stating that FDI to this region is driven by geographical and institutional factors, similarly to other transition economies, but there is evidence of a significant negative regional effect.

Foreign capital has played an important role in most countries during the 20-year transition to market economy. During the first decade of their transition, FDI in most of the Balkan region was low, most probably deterred by the unstable political environment (Estrin and Uvalic 2014). In the early 2000s, the growth of FDI flows has been based on only a few minimal conditions as is the restoration of peace and basic security, the beginning of economic recovery and modest improvements in the business environment (Kekic 2005). Economic recovery has generally been slow so that by 2011 three countries had still not reached their 1989 GDP level (Serbia, Montenegro and Bosnia and Herzegovina).

Estrin and Uvalic (2014) find that the levels of FDI to the Balkan economies can be explained by three factors: the size of the domestic economy, their distance from the investing economies of Western Europe and their remoteness from the EU and other major trading blocs and third, their institutional quality (more FDI into countries where institutions are more market supporting). They also found a positive correlation between the announcement of EU membership and FDI, though it is not clear whether this is because EU membership raises FDI per se—via reduced transaction costs and risk—or because EU membership leads countries to improve their institutions.

## 6 Western Balkans: Competition Between the Russian Federation and the European Union

The region is very diverse and comprises multiple sets of ethnicities, languages, religions, and cultures. What ties these multiple identities together, apart from their communist past, is their common envisaging of a European future: all of the Western

Balkan countries are EU candidate (North Macedonia, Montenegro, Serbia, Albania) or potential candidate countries (Bosnia and Herzegovina, Kosovo), even if they are marching toward this goal at a very different pace. In some countries, disenchantment with or plain discontent about further EU integration is mounting, while old and new political disputes are surfacing. Trust in the EU is unevenly spread across the region, ranging from over 70% in Albania to roughly 30% in Serbia (European Commission 2018c).

After the collapse of the Soviet Union, the Balkan region represented for Russia a buffer zone between East and West, an area where it is possible to employ a certain degree of influence since it is free from soviet legacies (Stefano 2018). Here, the post-Soviet giant can count on societal and cultural links and to a certain degree on trade. Even if in the last 2 years Russia has been busy on other fronts, it never stopped being interested in the region, keeping investments low, but political and cultural connections high. With some notable exceptions (Romania, Kosovo, the Bosniak community, and Albania), Southeast Europe looks at Russia as a potential ally and/or source of economic benefits (Bechev and Radelji 2018). The most affected countries are Serbia and Bosnia Herzegovina: in different ways, approaches and perspectives, but they are the ones Russia is looking to in strengthening its position in the region, above all after Montenegro's NATO accession and the imminent accession of North Macedonia.

Russian influence in Southeast Europe is shaped by both supply and demand. The Russian Federation has developed links to the region, in order to balance and compete with the West. But equally, local players have been keen to exploit their relations with Russia to achieve their own goals: maximize economic rents and enhance political clout (Bechev and Radelji 2018). Also, often, Russian investment reaches the region through Europe, with the Netherlands, Austria, and Cyprus as gateways (Bechev and Radelji 2018).

At the same time, feelings of betrayal in Western Balkans have been created by the European Union's refusal to open membership talks with North Macedonia and Albania, a move which was deemed by Jean-Claude Juncker, as a "major historic mistake" (Gray 2019).

Regarding Russian FDI in the region, Russian firms can generally be divided into two major categories: private and state-owned, both of which are generally supported by the Russian State when they internationalize, especially in the resource-intensive industries (McCarthy et al. 2009). Dikova et al. (2016) identify three key motives for the expansion of Russian firms through international acquisitions: desire to expand their raw materials base (e.g., resource-seeking investments), to obtain access to new markets (market-seeking investment), and to expand strategic resources (asset-seeking investments). According to Meyer (2015), the sole purpose of FDI is to use assets acquired abroad to enhance the operations of the investor in other markets and, adding to that, some researchers propose that the trajectory of Russian MNEs internationalization does not always fall into the traditional categories (Annushkina and Colonel 2013; Dikova et al. 2016).

Following the Uppsala model and the "psychic distance" it proposes, it is deemed more likely that Russian firms prefer their geographical and cultural neighborhood

for acquisitions and hence explain the dominant presence of Russian FDI in the Western Balkan countries, which are closely linked to Russia in territory, language, and culture (Kuznetsov 2011). Kostova (1999) proposes that the closer the "psychic distance" is between the investor and the receiver country, the more probable it becomes that these investments will be problematic, especially when the transfer of technologies, knowledge, or other intangible resources or strategic assets is in question.

Keeping that in mind and in the aftermath of the financial crisis and the EU sanctions, it is deemed helpful to investigate the stance of the Russian Federation and the EU toward the Western Balkans, an area upon which historically both the Russian Federation and the EU try to establish their influence.

## 6.1 EU's Footprint in the Western Balkans: Power of Attraction

The basic instruments of the EU regarding the Western Balkans are four. First is the Stabilization and Association Process (SAP). The SAP is the strategic framework supporting the gradual rapprochement of the Western Balkan countries with the EU. It is based on bilateral contractual relations, financial assistance, political dialog, trade relations, and regional cooperation. At the same time, contractual relations take the form of stabilization and association agreements (SAAs). These provide for political and economic cooperation and for the establishment of free trade areas with the countries concerned. Since the entry into force of the SAA with Kosovo in April 2016, SAAs are now in force with all Western Balkan candidate and potential candidate countries. This "European perspective" was reaffirmed in the Commission's February 2018 Western Balkans Strategy and in the Sofia Declaration following the EU–Western Balkans Summit of May 17, 2018 in the Bulgarian capital (European Parliament, n.d.).

The second instrument is the accession process. Applicant countries for EU membership must fulfil the Copenhagen political criteria. Candidate and potential candidate countries receive financial assistance to carry out the necessary reforms. Since 2007, EU pre-accession assistance has been channeled through a single, unified instrument: the Instrument for Pre-accession Assistance (IPA). The third instrument is the regional cooperation. One of the key aims of the SAP is to encourage countries of the region to cooperate among themselves across a wide range of areas. Lastly, visa-free travel to the Schengen area was granted to all Western Balkan countries except for Kosovo which, since September 2018, has entered into interinstitutional negotiations.

The accession process to the EU has brought about new economic institutional ties between the EU and the Western Balkan countries,[5] such as the Stabilization and Association Agreement (SAA) (Hake and Radzyner 2019). The SAAs replaced a number of interim agreements with the EU on trade and trade-related issues and were progressively negotiated with all Western Balkan countries and entered into force in the period 2004–2016.[6] The goal was to facilitate and deepen trade flows, in conformity with GATT 1994 and WTO, through preferential trade regimes (Hake and Radzyner 2019). The economic figures that follow the accession process come from the Instrument for pre-accession (IPA), with a budget of 11.7 billion euros for the period 2014–2020 (European Commission n.d.), and a proposed increased budget of 14.5 billion euros for 2021–2027 (European Council, n.d.). After the remarks of Jean Claud Juncker (Radosavljevic 2017) that there will be no enlargement for the next years (until 2020) the strategy for "a credible enlargement perspective for and enhanced EU engagement with the Western Balkans" (European Commission 2018a) offered a more positive note to the relations of the region with the EU. In 2018 alone, pre-accession assistance for the Western Balkans was to reach 1.07 billion euros while during 2007–2017 9 billion euros have been disbursed (EWB 2018).

At the same time, the European Investment Bank (EIB), since 2007, has financed projects totaling 7 billion euros and in 2017, the EIB signed financing contracts amounting to 330 million euros in the Western Balkans (EIB, n.d.). The Western Balkans can also receive financing through the European Bank for Reconstruction and Development (EBRD) which invested 1.1 billion euros in 2018 in the six Western Balkan countries and is planning to invest at least the same amount, if not more for the year to come (Sito-Sucic 2019).

The 2014 High Level Conference on the Western Balkans in Berlin,[7] and the establishment of the Berlin Process was another try by the EU to show its firm political commitment to a future enlargement toward the Western Balkans. With a proper agenda—known as the "Berlin Agenda"—more progress was to be achieved on economic governance as well as infrastructure connectivity projects, using existing financing programs such as Western Balkans Investments Framework (Hake and Radzyner 2019).

But even with the investments from the instrument of pre-accession, there seems to be a sizable financing gap (Radzyner et al. 2011). Grievson et al. (2018) spoke of a 12% of GDP investment gap per year in the period 2018–2022 in the Western Balkans as non-EU member States cannot access large EU cohesion and structural

[5]The purpose of this chapter is not an in-depth analysis of the EU–Western Balkans situation but to cover basic aspects of their relation to allow for a comparison with Russia and offer a perspective of the current situation based on their economic ties with the countries of the Western Balkans.

[6]For Albania, the SAA entered into force in 2009, for Bosnia and Herzegovina in 2015, for the former Yugoslav Republic of Macedonia in 2004, for Kosovo in 2016, for Montenegro in 2010 and for Serbia in 2013.

[7]The 2014 conference was followed by the 2015 Vienna Summit, the 2016 Paris Summit, the 2017 Trieste summit, and the London summit in July 2018.

funds until they are official members of the Union hence their fate becomes intertwined with other actors and investors such as the Russian Federation, China, Turkey, and the Gulf States.

Lastly, from a comparative point of you, it should be stated that the EU corresponds to two things: a *sui generis* international organization and 27 member states. From that point of view, the Western Balkans receive investments and funds both from the EU and its institutions but also from its member states as investors. This dual advantage the EU possesses offers great potential for influence and growth toward the Western Balkans.

## *6.2* **Modus Operandi** *in the Region: The Russian Federation*

Many researchers analyze the idea that Russia has "returned" to the Western Balkans. This idea though is deemed misleading. Post-Soviet Russia never quit the region, what changed since the early 1990s is the way Russia projects its power (d'Amora 2014). This change in the way Russia develops and projects power is primarily due to the interplay of four factors: constraints and opportunities stemming from war and peace dynamics in the Western Balkans, relations with Europe and the United States, Russia's self-perception and its power resource base (Secrieru 2019).

President Putin framed contemporary international relations in terms of strong competition with developed economies for markets, investments, and economic influence (President of Russia 2002). Shortly after, Russian elites started to present Russia as a "liberal empire" that could expand by attracting neighbors primarily via economic power and performance (Chubais 2003). As a result, Russian foreign policy acquired greater economic undertones at the same time that peace settled in the Western Balkans, allowing Russia to project its newly rediscovered mercantilism to grasp fresh economic opportunities in the region (Secrieru 2019).

While Russia did not become the Western Balkan's main trading partner or investor (with the exception of Montenegro), Russian businesses made significant acquisitions in strategic sectors such as energy, heavy industry, mining, and banking. With that said, economic domination is not always the goal, even the presence in certain domains gives "access" to a country and therefore to its society, people, and public perception. Both the EU and the Russian Federation are looking for that "access" to influence the region or as Secrieru (2019) put it "the mercantilist drive sought to create dependencies and endow the Russian state with political influence in the region," in other words, mercantilism was disguising Moscow's geopolitical objectives.

This competition between the Russian Federation and the EU regarding the Western Balkans triggered even further by the annexation of Crimea and the cancellation of the Russian-sponsored South Stream gas pipeline, strengthened the Russian interest in the region. Russian MNEs were encouraged to invest in strategic sectors and economic interests were followed by geopolitical and security ones. The grand aspirational objective of Russia's current policy is to deconstruct step by step

what it sees as an unjust unipolar regional order underpinned by Western institutions and to bring back what is deemed in Moscow to be a more natural state of play for the Balkans: multipolarity (Vuksanovic 2018).

As the EU is being more contested on the inside and its influence is decreasing due to the presence of other actors in the region, such as China, Turkey, and the Gulf States (Entina et al. 2018), it is only inevitable to question the possibility of European integration and for the Russian Federation to be deemed a feasible alternative.

## 6.3 *Russian Economic Connections in the Western Balkans*

As it was mentioned above, solely the presence of a country in strategic sectors of another country's—or region's—economy is deemed enough to allow access and influence over it and therefore control. For that reason, trade and investment account for a substantial part of Russia's leverage in the Balkans. On the surface, it is easy to discount Russia's economic presence (Bechev 2019). Even if the Russian Federation is not the biggest foreign investor in the region, the country has managed to supply gas and crude oil to the region making it somewhat dependent as the diversification process of the energy sector is really slow and time-consuming.

In more detail and concerning FDI, Russia accounted for 4.9% of FDI in Serbia in 2014, 4.6% in 2015, and 3.9% in 2016 while the EU's share was between 70% and 80%. Russian capital corresponds to around 10% of the economy, largely thanks to the Serbian oil and gas company NIS. In Montenegro, where Russian individuals and businesses play an outsized role in the real estate and tourism sectors, Russia's share fell from a high of 29.4% in 2006 to 5.5% in 2015 when measured in terms of corporate revenues (CSD 2018).

Even if the EU is spending far more on the region (see Figs. 2 and 3), the Russian Federation holds leverage as it invests to strategic areas while the EU has a more diversified investment portfolio that spans different manufacturing subsectors (Conley et al. 2016). Moreover, the Russian Federation almost in all countries of the Western Balkans is investing more than the country used to do or is back at 2010 levels of investment.

Russia has a strong cultural and historical affinity with the Western Balkan countries and therefore also has a way to apply soft power in the region (Bechev 2015). Tafuro-Ambrosetti (2019) claims that Russia's main soft power narratives boil down to two elements: anti-Western opposition and Orthodox brotherhood while Barber (2015) adds a third dimension, that of a more recent and relevant Russian strategy, directly exerting influence in the Balkan Peninsula: its economic commitment via increased investment, energy contracts, and humanitarian aid.

Only three Western Balkans countries have so far closed bilateral trade agreements with Russia, namely Albania (Trade and Economic Cooperation Agreements; Treaty for the Avoidance of Double Taxation) (Invest in Albania, n.d.), Bosnia and Herzegovina (trade and economic cooperation agreements) (Embassy of Bosnia and

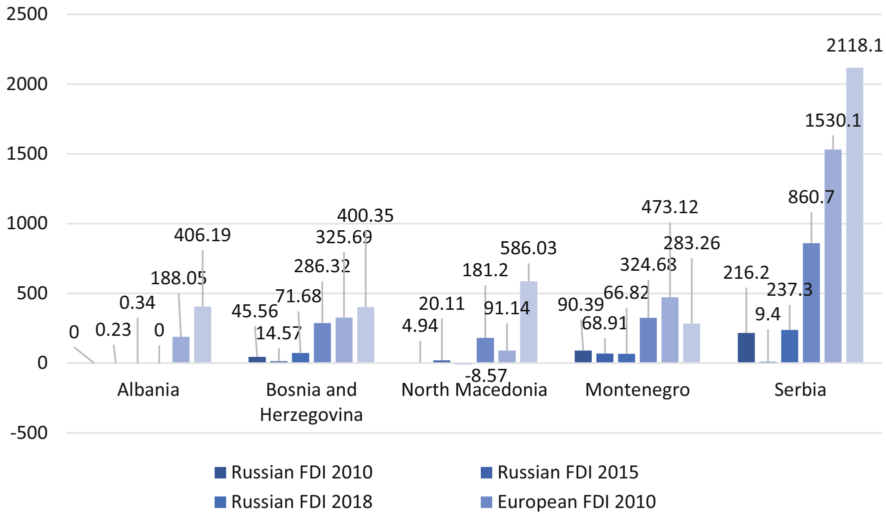


**Fig. 2** FDI inflow to Albania, Bosnia and Herzegovina, North Macedonia, Montenegro, and Serbia from the Russian Federation and EU-28 for 2010, 2015, and 2018. (Source: Calculations by the authors using statistics available from the Russian Central Bank, the Bank of Albania, the Central Bank of Bosnia and Herzegovina, the National Bank of the Republic of North Macedonia, the Central Bank of Montenegro, and the National Bank of Serbia. Sums refer to FDI from the EU Member States and not from other sources, i.e., money from structural funds or the IPA. No available date for 2010 for Albania. Statistics for Montenegro are for 2010, 2015, and 2017. No reliable data available for Kosovo)

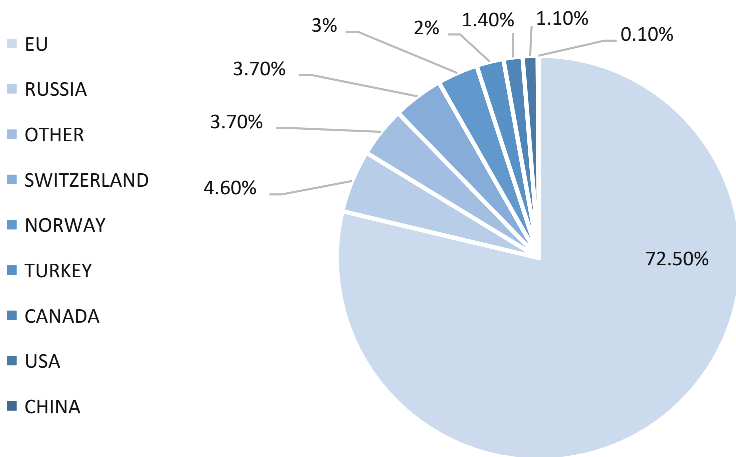


**Fig. 3** Foreign Direct Investment inflows in Western Balkans 2007–2015 (Source: European Commission 2018b) (See also for EU funding per country of Western Balkans)

Herzegovina Moscow, n.d.), and Serbia (bilateral free trade agreement) (Stojanovic 2019), while a trade agreement with Montenegro is currently under negotiation (Privacy Shield Framework, n.d.).

Despite their cooperation in certain sectors, FDI flows from Russia to the Western Balkans have been decreasing for several years. At the beginning of the century, Russia's position as the region's top economic partner (Hake and Radzyner 2019) has been decreasing with a further decrease or stagnation following the international sanctions imposed (Vladimirov et al. 2018). That said, Albania and Montenegro joined EU sanctions against Russia, imposed since March 2014 onward, while Serbia and North Macedonia decisively opposed to such a move.

The future influence of Russia on the Western Balkan region is open. To Russia, the Western Balkans have established themselves as "a transit region for its energy exports to Western European markets" and the sentiment is rather toward a preservation of the degree of influence rather than a competition with Brussels (Hake and Radzyner 2019). On the international political scene, Russia is seen as a tactical player taking swift decisions and acting flexibly (Bechev 2015) maintaining its influence on a region that is and will be of great importance.

## 7 Conclusions

In order for the Russian Federation to be able to attract more FDI, there need to be improvements of the investment climate, of the economic, as well as the regulatory and legal framework for public–private partnership (PPP) and development of the leasing scheme of investment attraction (Oleinik 2017). Adding to that, FDI is one of the key factors of the modernization and diversification of the Russian economy but they are only concentrated in a few regions. In that way, the set of FDI determinants could be used to increase the efficiency of regional programs aiming at improving the investment attractiveness of Russian regions. The situation becomes even more complicated depending on what someone's point of view is toward the Russian Federation. The macro stability encourages bond investors, but the slow growth dissuades equity investors.

Moreover, the decrease of FDI could be covered by investments from international organizations in which Russia is a member. For example, the New Development Bank mobilizes resources for infrastructure and sustainable development complementing the existing efforts of multilateral and regional financial institutions for global growth and development (Kirton 2015).

Due to the 2008–2009 financial crisis, FDI had decreased and before the country was able to bounce back, in 2014, the international developments further stagnated investments in the country. Once again, when the country was recovering, FDI in 2018 reached its lowest level due to more sanctions imposed and has since saw a timid increase in FDI. It is noteworthy that FDI to the Russian Federation decreased two times more after the European Sanctions than the decrease due to the 2008–2009 crisis. After the two big recent hits, the situation in Crimea and in the Kerch Straits,

Russia has cultivated the image and reputation of a somewhat unstable and unpredictable partner. Internationally, this behavior of Russia is highly criticized as countries find the imperialistic tendencies of Russia contrary to their beliefs. Having stated that, Russia's economic imperialism cannot be fully monitored and seems to be the course Russia is following as it can offer the country a lot of opportunities to fulfil its agenda of gaining access and influence over other countries.

In its efforts to balance the scales, the Russian Federation has introduced an import substitution model so as to mitigate the negative results from the lack of FDI by augmenting national production and economic sovereignty. Adding to that, anti-offshoring legislation seems to have a positive effect on investments coming from OFCs, as the levels decreased and investments in the country were promoted as an alternative.

But Russia was not only a receiver of FDI but also an exporter. Since the EU sanctions and the negative effect they had on the Russian Federation, it was deemed interesting to compare the economic presence of the EU and of the Russian Federation to the six Western Balkan countries. Russia and the Western Balkans, all economies in transition, have similarities when it comes to culture, language, and religion. In spite of this, Russia is able to project its soft power playing to their similarities. Even though it is not their main investor, the influence it maintains is of great importance as it gives Russia a footing in projecting its interests to the region. By investing in strategic sectors as is the energy sector or by financing their similarities Russia is playing to its advantage by increasing its positive public perception while keeping the counties dependent on its energy exports.

Even though there is said to be a "Balkans" effect on FDI, FDI in the region is mainly driven by geographical and institutional factors, similarly to other transition economies, despite the evidence of a significant negative regional effect. The multiple ethnicities, languages, religions, and cultures of the Western Balkans are a true testament to their diversity. Their communist past and EU perspective offer the perfect example as regards the competition between the EU and the Russian Federation in the region with one country representing the past while the other the future possibility. The Western Balkans are now the Russian Federation's buffer zone after the collapse of the Soviet Union with strong societal and cultural links, trade and FDI inflows. Serbia and Bosnia and Herzegovina are the two Western Balkan countries with closer affiliations to the Russian Federation as Russia received a major setback by Montenegro's accession to NATO and the imminent accession of North Macedonia. At the same time, the EU faced also major setbacks when, firstly, it was announced that for 5 years there would not be any enlargement and secondly, when it failed to open membership talks with Albania and North Macedonia. The growing sentiment in the region is that the EU expresses its "desire at a distance" meaning that while it wants as a sphere of influence the region of the Western Balkans, it keeps those countries at a distance, at an arm's length and it keeps playing the "neighborhood" card when it suits its narrative, especially after the 2016 Global Strategy.

The key motives for the Russian Federation are the strategic investments and the new markets that the Western Balkans offer playing to the "psychic distance"

between Western Balkans countries and Russia, while at the same time the EU accession perspective brought about new economic institutional ties between the EU and the Western Balkan countries. The increased budget spending of Russia and the EU indicates an increased interest in the region and with that comes increased influence.

Moreover, Russia did not return to the Western Balkans, it never left. It simply changed the way it projects its power and influence, adapting to the new global evolution. If international relations, as President Putin said, are a fierce competition with developed economies on markets, investments, and economic influence, then the Western Balkan countries are the ticket in winning the "international competition." Russian economic policy is beginning to have greater economic undertones as it rediscovers mercantilism to grasp economic opportunities in the region, and economic interests are always followed by security and geopolitical ones.

Solely the presence of different actors in the region can question the EU integration of the Western Balkan countries. In its efforts to balance the scales, even turn them to its favor, the EU is investing more than the Russian Federation but at the same time Russia is maintaining its leverage over the strategic sectors of the economies of the Western Balkan countries.

Conversely, the EU is projecting its power of attraction, its European prospect. By being by far the biggest investor in the region, the EU is trying to achieve the same thing as Russia. This tug of war between the Russian Federation and the EU over a sphere of influence results in divisions in the countries of the Western Balkans as some are pro-European and others are pro-Russia. Even if the European sanctions aimed at giving a hit to the Russian economy, the country proved that it can stand against a Union of 27 member states, perhaps not in FDI terms but in terms of influence. The EU may have the FDI and funding advantage but Russia maintains its influence by investing in strategic sectors making somewhat of a "Russian power of attraction."

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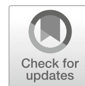
# Sovereign Debt Crisis in Greece and Its Relation with Foreign Direct Investment and Competitiveness in Greece




**Aristides Bitzenis**

**Abstract** The current European financial crisis is a triple threat and the austerity measures that have been pursued to tackle it (at least so far) have led to a fiscal trap that slides into a deflationary vortex which, on the one hand, pushes economies into a recession by increasing the number of the long-term unemployed, and, on the other hand, keeps their central governments' deficits at risky levels, thereby avoiding unsustainable development of their external and/or public debt. Greece is permanently one of the Eurozone countries that performs poorly in the Institute for Management Development's annual competitiveness surveys. A change in competitiveness policy is needed in order for the expectations of enhancing competitiveness to come from a realistic basis. The rapid increase in Greek FDI outflows over the past decades (and before the crisis) could theoretically be attributed to the influence of the euro. The relatively low attractiveness of foreign direct investment inflows in Greece is attributed to ineffective public governance, high taxation, inadequate infrastructure (in some sectors), and unfavorable macroeconomic conditions. The peculiarities of foreign direct investment (outflows) from Greece to foreign countries foresee positive externalities in the Greek economy. This means increased tax revenues from increased GDP and expectations for new foreign direct investment inflows, and also, increased skilled employment in Greece, and increased competition among foreign companies over non-international Greek companies, which do not internationalize their activities, but reinforce competitiveness of non-international Greek companies over multinationals.

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## 1 The Sovereign Debt Crisis in Greece as "Part of a Broader European Problem"

The current European financial crisis is a triple threat and the austerity measures that have been pursued to tackle it (at least so far) have led to a fiscal trap (Hannsgen and Papadimitriou 2012) that slides into a deflationary vortex (Bitzenis et al. 2013, p. 8) which, on the one hand, pushes economies into a recession by increasing the number of the long-term unemployed, and, on the other hand, keeps their central governments' deficits at risky levels, thereby avoiding unsustainable development of their external and/or public debt. The triple European problem can be described as follows:

- First, a shortage of bank capital as evidenced by their inability to stimulate market liquidity.
- Second, a public debt accumulation to levels that are considered impossible to be implemented and which in turn requires the prolongation of austerity policies.
- Third, the recession or the anemic economic growth at best.

In order to provide liquidity to crisis-hit Member States of the EMU through the Eurozone, mechanisms were set up to tackle this problem which was accompanied by the European Commission's demands for fiscal consolidation. Accordingly, the adapted prescription of "shock treatment" (due to the assistance of the International Monetary Fund and the characteristics of Greece's participation in the Economic and Monetary Union) for the Greek case aims to sustain (debt service) the country's political debt by stimulating competitiveness and fiscal consolidation:

- Firstly, through the stimulation of competitiveness using the process of policy reform to upgrade public administration and liberalize markets, and through internal devaluation, as currency depreciation is impossible to occur due to the common currency.
- Secondly, through fiscal consolidation for the implementation of the Stability and Growth Pact (e.g., a gradual reduction of fiscal deficits to 3% of GDP).

The first impression created for the prospects of recovery of the Greek economy according to all the abovementioned provisions is the importance of private foreign direct investment (FDI) and private domestic direct investment, as the commitments of the Memorandum of Understanding leave little or no room for fiscal expansion up to 3% of GDP but require exorbitant budget surpluses of 3.5% of GDP per year.

The importance of foreign direct investment in the current state of the Greek economy is easily understood by its ability to be substituted for public investment. However, since the size and characteristics of the Greek recession indicate that the levels of these inputs, at least in the short term, will come about as a result of privatization, the importance of the corresponding Greek outflows for stimulating employment and growth should not be overlooked.

## 2 Foreign Direct Investments, Competitiveness, and Their Importance in the Sovereign Debt Crisis

Foreign direct investment affects the host country (directly and indirectly) in both positive and negative ways. The externalities of foreign direct investment from the host country are reflected in the transfer of technological and capital resources (e.g., stimulating productivity due to the former and employment for the latter), the balance of payments, and employment (e.g., displacement of competition). Multinational corporations can play an important role in both the productivity and the size of host country exports, and the size of positive externalities depends on the absorption capacity of the investment (Bitzenis and Vlachos 2012) presented by the host country. This ability is a result of the characteristics of the business environment, the level of competition between businesses, and the quality of institutions.

Accordingly, foreign direct investment creates both costs and benefits for the country of origin (Bitzenis and Vlachos 2012). Its disadvantages are reflected in the loss of tax revenue, the balance of payments, and the level of employment. The balance of payments is adversely affected by the outflows of capital required for financing and also where direct investment abroad replaces exports or aims to import production transferred overseas. Also, the transfer of production abroad implies an immediate decrease in employment in the country of origin. On the contrary, the benefits include the repatriation of profits and the case of increased exports from the parent company to the subsidiary. Finally, exposure to foreign markets creates further skills and knowledge (i.e., ownership advantages).

All of the above take precedence over direct investment from and to the rest of the world which according to Dunning's (2001) eclectic example,[1] is the result of combining the advantages of multinational ownership, host country location, and related internalization that determine the success of direct cross-border investment. The role of the country of origin in the above process is illustrated in the theoretical "cost of distance investment"[2] (Hirsch 2005, 2012) which describes the costs resulting from the negative effects of economic, legal, institutional and other factors on value added through cross-border activities (Porter 1985, pp. 11–15). Positive externalities in the country of origin are the result of the added value that the country of origin acquires when "scale effects" outweigh those of "substitution." A good example is a horizontal direct investment in a tertiary sector of a foreign country that does not severely affect employment in the country of origin as it does not include relocation costs and on the other hand, increased taxable profits.

Although there is evidence supporting the relationship between foreign direct investments and economic growth in Greece in the long-term time frame

[1]The reference to the selective example is due to its recognition. A more complete picture, however, of the determinants of FDI from abroad provides the universal model (see Bitzenis and Papadimitriou 2011).

[2]Free definition of the term "distance premium penalty."

(Georgantopoulos and Tsamis 2011), doubts have been expressed about the short-term time frame (Alexiou and Tsaliki 2007). The lack of direct positive externalities has also been attributed to the relatively (intra-euro area) low level of FDI inflows from abroad (Xiao 2008). The size of the latter remains relatively low at around 10% of GDP. In addition, as shown by recent studies, foreign direct investment has in many cases contributed to the increase in the concentration of the market of destination, while positive externalities are limited.

Multinational enterprises acquire the most profitable businesses in Greece and are actively involved in upgrading their processes (Georgopoulos and Preusse 2009). They choose to penetrate sectors and areas with relatively high productivity rates and their direct impact on domestic productivity is negative, especially in the manufacturing and high-tech sectors (Monastiriotis and Jordaan 2010). The majority of foreign direct investment is concentrated in the more developed regions and the positive externalities are of a balancing nature, as productivity impacts are mainly negative in the main urban areas and mostly positive in the regional areas (Monastiriotis and Jordaan 2011). Outputs of foreign multinationals are usually more efficient than domestic ones, but positive externalities mostly relate to small- and medium-sized enterprises (SMEs) (Petroulas 2007). For example, foreign multinationals in the tourism industry, which are larger in size and better performing than their competitors, have positive externalities only to their partners who choose to reinforce their market position (Anastassopoulos et al. 2009).

Factors that determine the attraction of foreign direct investment from abroad characterize the competitiveness of the Greek economy. The relatively low attractiveness of foreign direct investment is attributed to ineffective public governance, high taxation, inadequate infrastructure (in some sectors), and unfavorable macroeconomic conditions (Pantelidis and Nikolopoulos 2008). While both accession to the European Union and the Economic and Monetary Union play an important role in the flow of foreign direct investment (e.g., see Baldwin et al. 2008), it did not lead to the establishment of the country as a production base for multinationals (Georgopoulos and Preusse 2006).

Regarding the determinants of attraction and repulsion of foreign direct investment flows in Greece from abroad in the 1990s, following the Maastricht Treaty, the statistical picture of FDI flows was not clear, since the weight was shared between the characteristics of the multinational, the characteristics of the penetrating industry, and the advantages of installation in Greece (Barbosa and Louri 2002). Until the early years of the euro, multinationals' penetration motives were largely market-driven (Bitzenis et al. 2007) and disincentives were reflected in its bureaucracy, taxation, corruption, and structure of the labor market (Bitzenis et al. 2009). Foreign direct investment inflows after the introduction of the euro and before the crisis that led to the collapse of the Greek economy have been attributed to market size, increased trade, and labor costs (Leitao 2010).

The fact that the market size has emerged as the most decisive factor in the past decade reveals the impact of negative expectations for market growth during the crisis, as it is only recently and with the contribution of privatization that foreign direct investment inflows are moving to precrisis levels. It is also important to note

that the importance of skills disappears when market dynamics are a determining factor (Blonigen et al. 2007), and therefore any policy of stimulating attractiveness should not be taken into account.

The rapid increase in FDI outflows from Greece over the past decades (and before the crisis) could theoretically be attributed to the influence of the euro, as it is argued that the euro promotes the number of trade and FDI flows significantly (Baldwin et al. 2008). The fact, however, of the geographical proximity (between host and home country of the multinational) of Greece's location requires further analysis, as Greek multinationals have channeled significant amounts to the countries of Southeast Europe and have gained significant market shares in that region. The holistic approach of Bitzenis and Vlachos (2011) refers to the fact that the liberalization of the former socialist economies in the Balkans and Turkey's "Europeanization" through its accession contributed to the rapid increase in direct investment outflows from Greece to the South-Eastern Europe. The impetus for this particular penetration of Greek multinationals was the opportunity to enter into new markets, the acquisition of strategic resources, low labor costs, geographical and cultural proximity, and the lack of investment interest from the West. Political developments have also contributed to the development of Greek multinationals, in particular the upgrading of the Athens Stock Exchange and the Greek Balkan policy. The liquidity problems, however, brought about by the debt crisis, threaten the leading role of Greek multinationals in South-Eastern Europe.

Regarding the share of foreign direct investment in various sectors/industries (Bitzenis and Vlachos 2011), from Greece to foreign countries over the past decades (and before the crisis) mainly focused on services, first of all, financial and to a lesser extent telecommunications. The benefits to Greek multinationals were increased turnover through access to new and emerging markets, diversification, and ownership benefits through the internationalization of the activities of the emerging markets.

Studying the motives, incentives, and direction of direct investment from Greece to foreign countries is also useful in assessing the externalities of Greek multinationals' activity in the Greek economy. Although there is no relevant empirical study in the literature so far, the Bitzenis and Vlachos (2013) case study draws preliminary conclusions by investigating the type of direct investment from Greece to foreign countries and the strategy of Greek multinationals. Specifically, the horizontal placements of Greek multinationals aim to exploit the advantages they already possess through reproducing most of their activities abroad. For example, Greek multinationals in the financial sector support measures to share neighboring emerging markets through the benefits of economies of scale. Horizontal expansion in the service sector, i.e., the majority of FDI from Greece, does not entail a substitution between foreign and domestic employment, as there is no relocation.

Thus, given the particularities of direct investment from Greece to foreign countries, it appears that the effects of scale outweigh those of substitution. Positive externalities include:

- The increase in turnover (and therefore tax revenue and cash available for new investments) resulting from the expansion of activities into new markets
- The stimulation of specialized employment in the country resulting from the need to extend strategic planning and management units to the parent company
- The competitive advantage over Greek companies that do not internationalize their activities, but also in stimulating competitiveness in relation to competing multinationals.

## 3 The Competitiveness of the Greek Economy

Unfortunately, Greece is permanently one of the Eurozone countries that perform poorly in the Institute for Management Development's annual competitiveness surveys (http://www.imd.org/wcc/), especially in the legal field, the institutional framework, and the tax framework. The competitiveness of an economy is characterized (in relation to other economies) by the quality of human resources, infrastructures, regulations governing the product/service and labor markets and the legal and institutional frameworks in general, but also by the size of the tax burden which determines both export performance and the attractiveness of foreign investors. Although the country has made some progress in the attractiveness of the economic environment over the last years, according to the Doing Business Index, it ranked in the top 100 among the 183 countries involved in the Ease of Doing Business survey (World Bank and International Finance Corporation 2011), a position that has improved significantly through the memorandum since the World Bank ranks Greece in the 60th position according to Doing Business 2016 Rank (World Bank Group 2016), while the World Bank ranked Greece in the 58th position according to Doing Business 2015 Rank position (World Bank Group 2015). In the last years during the SYRIZA government, we had a significant deterioration of the standing place, so Greece stands in the 61st position according to Doing Business 2017 Rank (among 190 countries) (World Bank 2017), in the 72nd position according to Doing Business 2018 Rank (among 190 countries) (World Bank 2018), and in the 79th position according to Doing Business 2020 Rank (among 190 countries) (World Bank Group 2019).

Improving competitiveness is crucial to the levels of prosperity of an economy that coexists in a globalized environment, both economically and politically, as in the case of the European Union and the Eurozone. The importance of competitiveness is becoming more critical now than ever, as the literature (see Bennett et al. 2008) demonstrates that receptivity[3] and extroversion can accelerate productivity improvement and export performance of the Greek economy and thus its way out of the crisis.

[3]Free interpretation of the term "openness."

### *3.1 Measures to Strengthen the Competitiveness of the Greek Economy for the Benefit of Small and Medium Enterprises*

The expectation of boosting the competitiveness of the Greek economy through internal devaluation is based on the theoretical treatment of simultaneous deficits[4] (fiscal and current transactions) within the euro area (Vlachos 2013). Specifically, the customized recipe for the "shock treatment" that was chosen for the Greek case aims:

- Firstly, to stimulate competitiveness through reforms to upgrade public administration and liberalize markets, and through internal devaluation, as currency depreciation is impossible due to the common currency.
- Secondly, to encourage fiscal consolidation for the implementation of the Stability and Growth Pact (e.g., a gradual reduction of fiscal deficits to 3% of GDP).

Only from the effects of customer relations and earnings (for an overview see Vlachos 2013) does the need for both fiscal consolidation and reforms easily emerge. The benefits of internal depreciation, arise from its theoretical contribution to reducing simultaneous deficits. With regard to the budget surplus recorded in 2014–2019 Greek annual budgets (after 5 years of applying the internal devaluation), it should be emphasized that we have an increase of the shadow economy due to decisive taxation burden for both enterprises and natural persons, and a continuing increase in both public debt and private debt for legal entities and natural persons and an increase to their debt obligations (the latter in the tax authorities and insurance agencies). An example at the beginning years of the Greek sovereign debt crisis in Greece and as for the Greek trade balance in 2012, according to data released by the United Nations, exported services surpassed imported goods by $18.5 billion and are lagging behind the top performance of $25.1 billion in 2008 (the last year of economic growth in Greece), mainly due to exports lagging behind in travel and transport. On the other hand, according to data released by Eurostat, exports of products from Greece in 2012 were below their respective imports by 20 billion euros. However, this deficit is 55% lower than the corresponding deficit in 2008 due to the slowdown in Greek imports of products from the European Union and the increase in Greek exports to third countries.

On the other hand, in addition to the "recessionary" contribution of domestic depreciation to reducing the simultaneous deficits of the Greek economy, there is also a boost in productivity to attract investment. A glance, however, at the data released by Eurostat is enough to indicate the correlation between productivity (valued at labor cost changes) and private investment. Regarding the reduction in real labor costs per unit of production (at base prices in 2005), Greece has been a

[4]Free version of the term "twin deficits." The "twins" performance was preferred "simultaneously," since the latter means that deficits always move in the same direction regardless of the circumstances. However, this is not confirmed by the literature.

champion in the Eurozone in that years due to the memoranda and even more so than its "persecutors" (i.e., countries that also experienced similar problems and sovereign debt crisis and substantial reduction of labor costs such as Cyprus, Portugal, and Spain). The Greek economy's lead in improving this index (which began with the implementation of the Memoranda of Understanding) has not signaled any substantial increase in investment flows from abroad so far, although its performance is significantly higher than in the previous decade. That is why the prospects for foreign direct investment inflows in Greece for the short term are focused on privatization.

This has been, and is to be expected, of course, since the effort to stimulate competitiveness is one-dimensional as it focuses on reducing the cost of production. The literature shows that productivity, in theory, is determined by factors beyond labor costs, while empirical findings lead to the conclusion that labor costs do not affect the return on capital. In theory, both the Kaldor paradox (the positive correlation between exports and labor costs for developed economies) and a recent literature review (Syverson 2011) show that productivity is determined by expertise, technology, and influences of skills on the business environment. On an empirical level, the application of internal devaluation is dangerous to the economy's attractiveness to foreign direct investment. In particular, wages that exceed labor productivity do not affect the return on capital invested, following changes in the economic, political, and institutional environment (Katsimi et al. 2011).

Also, all identifiable business activity indicators (such as the World Bank's "Ease of Doing Business") consider that labor costs play a secondary role in the size of the business. In conclusion, labor costs are of major importance only for the competitiveness of less developed countries that accept labor-intensive investments. For this reason, data released by Eurostat show that Greece not only continues to fall short of expectations (in line with the euro area average) as a host country for foreign investment but also the level of investment (FDI inflows in Greece) that will be achieved in the following years is only possible in the short term through the completion of the long time-awaited privatizations.

In conclusion, there is an urgent need for a renewal and redefinition of policy objectives to stimulate the competitiveness of the Greek economy. Moreover, the solutions proposed by studies addressing contemporary deficits in Greece (see Kalou and Paleologou 2012) emphasize that competitiveness will be improved through short-term constraints on rising price and wage levels and through technological change and quality improvement which is the main goal.

## 4 Summary and Conclusions

The changes brought about by the application of the shock treatment recipe in the Greek economy highlight the prominent role that direct private investment will play in the latter's expected recovery, and in particular, at least in the first place, from abroad. Correspondingly, focusing on efforts to stimulate Greek competitiveness

and by extension, extroversion, is definitely a move in the right direction. However, internal devaluation is now jeopardizing efforts to stimulate competitiveness and thus the prospect of recovery. First, domestic depreciation is not linked to the attractiveness of the Greek economy to foreign direct investment and, more generally, to the extroversion of developed economies. Second, the crisis of the Greek economy, which is attributed to the implementation of internal depreciation, threatens the return on the capital investment that largely follows the changes in the economic, political, and institutional environment. Inevitably, a temporary and short-term improvement in competitiveness requires a restriction on the increase of short-term price levels and wages. In the long run, substantial improvement will come through technological change and quality improvement.

Therefore, a change in competitiveness policy is needed in order for the expectations of enhancing competitiveness to come from a realistic basis. With regard to the limited positive externalities of foreign direct investment in the Greek economy so far, there are elements that do not reverse expectations for their contribution to the expected recovery. On the one hand, there is evidence supporting the relationship between foreign direct investment and economic growth in Greece over the long term. On the other hand, the limited positive externalities are attributed to the relatively (intra-euro area) low level of inflows.

Finally, improving competitiveness also means stimulating openness of the country (in both trade and FDI). This could accelerate the country's exit not only from the much-publicized export surge but also from the externalities of foreign direct investment outflows. The peculiarities of foreign direct investment (outflows) from Greece to foreign countries foresee positive externalities in the Greek economy. This means increased tax revenues from increased GDP and expectations for new foreign direct investment inflows, and also, increased skilled employment in Greece, and increased competition among foreign companies over non-international Greek companies, which do not internationalize their activities, but reinforce the competitiveness of non-international Greek companies over multinationals.

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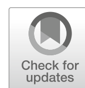
# Sector Analysis and Economic Growth in Greece: The Domination of Tourism over Other Sectors




**Konstantinos Spinthiropoulos, Christos Nikas, and Eleni Zafeiriou**

**Abstract** The present chapter examines the impact of significant sectors of the Greek economy and their relationship with economic growth. The variables employed for this study involve tourism-generated GDP, money supply, construction and taxation, and economic growth in Greece while the methodology employed is the multivariate autoregressive VAR model. The long-term relationship between GDP and the variables examined was validated for the period between 1965 and 2015. According to our findings, the "growth engine" for Greece seems to be tourism, rather than the manufacturing sector, while they confirm a shift away from the tertiary toward the primary sector. The results provide policy-makers with effective policy tools for the simultaneous economic growth of the two aforementioned sectors.

## 1 Introduction

Greece, a purely agricultural economy, has become within the last half century an economy with a remarkable service sector (Delivani 1991). On the other hand, the "growth engine" for Greece according to Delivani and Nikas (2011, 2013) was tourism rather than manufacturing, a conclusion that is in line with Brida and Pulina (2010) who considered tourism as a short-term and long-term economic growth factor confirming the so-called tourism growth hypothesis, while technological progress is one of the key factors in economic development, according to Solow (1957).

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The expansionary fiscal policies adopted and financed through expansionary monetary policies in the 1980s and 1990s have led to a huge public debt. The problem was realized when the supply of money had to be balanced with the entry of the country into the Economic and Monetary Union in 2001. The changes in the public spending policy were rather limited. The economic downturn initiated for all European countries had severe consequences for the Greek economy. Since 2010, as part of its fiscal consolidation strategy, Greece has introduced an eight-bracket system that lasted until December 31, 2012. Based on the income tax scale, all types of income were unified and taxed with progressive tax rates ranging from 10 to 45% for income over 100,000 euros (LAW No. 3845, Greek Government Newsletter 2010). To achieve a sustainable fiscal policy, consideration must be given to differential taxation of tax base categories, as well as a cautionary increase in public debt or even a reduction of public debt. There are studies that argue corporate and personal income taxes are the most harmful to growth, while consumption, environment, and property taxes are less harmful (OECD 2008).

The Greek economic crisis has in turn affected a number of sectors with the exception of the Greek tourism industry which has grown rapidly after 2008, despite the prolonged economic recession. In figures, the Travel & Tourism's direct contribution to GDP amounts to 13.2 billion euros (USD14.7 billion), 7.5% of total GDP in 2016, projected to increase by 7.5% in 2017 and by 4.5% pa in 2017 to 22.1 billion euros (USD24.6 billion), 9.6% of total GDP in 2027 (WTTC Travel and Tourism Economic Impact 2017).

Furthermore, the findings of the World Tourism Organization (2017), without underestimating the contribution of other manufacturing sectors to Greece's economic development, justify further research to highlight the importance of the tourism sector in Greece in relation to the country's productivity during the deep economic recession (Dritsakis and Athanasiadis 2000; Payne and Mervar 2002). Tourism industry growth varies from year to year because it is influenced by exogenous factors (Schubert and Brida 2009). At the same time, it reinforces the business sector because industrial and agricultural production may be positively influenced by the inflow of tourists (Spinthiropoulos et al. 2018a, b).

The tax system in a nonindustrialized country that has pursued a capital-intensive policy to adopt the new productive methods of Western developed countries is a determinant for the generation of income inequalities. Thus, the horizontal increase of taxation due to the measures imposed on the country by the International Monetary Fund in 2009 played a significant role in the evolution of domestic GDP. In short, since the time Greece entered into a loan agreement with the International Monetary Fund, the Greek economic policy was implemented only with the approval of the country's lenders, namely the European Commission, the European Central Bank, and the International Monetary Fund.

With these assumptions in mind, we will focus on studying the contribution of tax revenue, tourism receipts, and the primary sector's contribution to the Greek economy for the period between 1970 and 2016 and its impact on economic growth.

The present chapter consists of five sections and is organized as follows: the introduction section, followed by a brief literature review presented in the section

titled “Literature Review” while the “Model Data Specification” section presents the analytical framework, empirical methodology, and empirical results of our research. Then, there is the section containing the results and finally the bibliography.

## 2 Literature Review

A great number of scientific articles have studied the impact of fiscal policy on a country’s economic growth in periods of economic crises. For instance, Barro (1990, 1991) analyzes the consequences of ideal fiscal policy selection within a specific model where the growth rate drops as tax levels rise in a period of a financial downturn. In their models, most researchers used the share of government spending as an endogenous variable to explore the relationship between government spending and economic growth (Drakopoulos and Theodosiou 1991; Chamley 1986). Government spending (in GDP), however, is not the only variable to define economic development and the economic policy’s level of achievement.

Regarding the empirical studies, different methodologies with different research have been implemented. To be more specific, with the assistance of regression models, Koester and Kormendi (1989) researched the connection between the overall rate of taxation and the development of the economy. The findings of their investigation did not show a clear causal relationship between the variables (Folster and Henrekson 2001).

Other researchers used a different method in order to investigate the relationship between taxation and economic growth. For example, Gemmell et al. (2006) used a panel data of 22 OECD countries for the period between 1970 and 1995 and identified a depressing effect of the so-called “distortionary taxes,” which include taxes on income and property. Kneller et al. (1999) and Collignon (2013) confirmed these findings by providing new evidence on the long-run impact of distortionary taxes on growth in OECD countries. By using cross-country regression, Lee and Gordon (2005) and Levine and Renelt (1992) discovered an important reverse connection between the variables they used. More specifically, they found a significant negative correlation between statutory corporate tax rates and growth for 70 countries during 1970–1997. Similar outcomes are reported by Dackehag and Hansson (2012). They investigated how statutory corporate and personal revenue tax levels affect financial development by using panel information for 25 rich OECD nations for the period 1975–2010 and discovered that both corporate and personal revenue taxation have a negative impact on financial development.

In comparison to these results, Bernardi (2013) and Szarowska (2013) proceeded with a different analysis. They conducted an aggregate analysis of tax trends across the member states of the Euro Area (EA-17) and a country-by-country disaggregated assessment for the period 2000–2014. They discovered that benefits from direct to indirect taxes do not seem to be as straightforward as claimed by the previous researches. On the contrary, they predict that the tax shift may exacerbate the

spreading financial decline across the European Union, especially as an impact of the overall implementation of restrictive fiscal policies by nearly all member states.

In the tourism sector, economic growth and social progress inevitably result from the correct combination of taxation and stimulation of the tourism industry (Kollias and Paleologou 2006; Agell et al. 2006). This is why most countries are attempting to create and expand their touristic potential, i.e., through infrastructure and the development of other tourist activities, as rapidly and effectively as possible. The question arising from this refers to the connection between tax revenue, tourist receipts, and the primary sector's contribution to a country like Greece during periods of economic recession.

The Greek governments' decision was the further growth of the tourism industry. In the midst of a prolonged financial downturn, tourism offers alternatives for future economic growth in countries (National Statistical Service Greece 2017).

International Organizations, relevant to the tourism industry, such as the World Tourism Organization (2017), argue that despite the financial downturn of the last century, tourism is one of the most successful industries. The significance of tourism for Greece is manifested by the fact that it turned out to be more important than traditional sectors such as construction and agriculture. Indeed, Greece has been able to transform from a solely rural economy to an economy with an outstanding service sector since the 1970s.

From our point of view, it is interesting to study the role of the construction sector, the supply of money, and the product produced by tourism. An additional reason for such a study is the timing of our research. This is because it coincides with the Greek economy's attempt to return to normalcy by adopting and implementing the agreements it signed with its creditors.

For over three centuries, the construction industry has been Greece's "engine of growth" (Nikas 2006). Katrakilidis et al. (2013) and Rowthorn and Wells (1987) provide motivation for further study in order to highlight the importance of construction rather than other industries of the Greek economy by exploring the validity of the Kaldorian theory (Kaldor 1966). However, Delivani and Nikas (2011) added that Kaldor's theory is valid, but the driving force of the Greek economy is services instead of manufacturing.

Galani (1993) argues that Greece has been able to convert from a purely agricultural economy into an economy with a notable service sector since the 1970s. The growth of the service sector has inevitably facilitated the expansion of the banking system, where the country has boomed the tourism industry since 1980 through the money supply (Spinthiropoulos et al. 2010). For a country like Greece, the service sector and particularly tourism, are crucial, particularly during a period of extended economic recession. Dritsakis (2004) and Zortuk (2009) asserted that the tourism industry plays a central role toward the growth of the Greek and the Turkish economy, respectively.

Since 2010 Greece has introduced three fiscal adjustment programs and since 2015 the banking system has been subject to limited capital controls. Under these conditions, the building sector was unable to respond, but despite the financial downturn in Greece, the tourism industry has shown resilience (National Statistical

Service 2017). But did the level of taxation negatively affect the growth engine of the Greek economy? Would the tourism industry be able to deliver even more if the taxation level was targeted and obviously lower?

For a country like Greece, particularly during a period of extended economic recession, it is very crucial to introduce a suitable tax policy and achieve the growth of tourism, the primary and the manufacturing sector. According to the literature review, many researchers support that when a country approaches the point of "financial maturity" the supremacy of the manufacturing sector is contested (Delivani and Nikas 2013). Usually, it is followed by a process of deindustrialization and thus the contribution of the tertiary sector to growth and new job offer increases.

However, in the case of Greece and in the period of prolonged economic downturn, the country needed to borrow funds in order to serve its public debt. The only "safe way of borrowing" seemed to be the International Monetary Fund. Greece's fiscal consolidation program was quite ambitious because the structural budget balance declined from −14.8% of GDP in 2009 to −1.0% of GDP in 2012 and the economy continued to contract by 2013 (−4.9% in 2010, −7.1% in 2011, −6.4% in 2012, and −4.0% in 2013). At the same time, the imposition of high tax rates has become horizontal and without exceptions. Therefore, high tax rates also applied to the service sector and tourism in particular.

Despite the severe economic crisis, the tourism industry continued to grow in Greece. In addition, both the tourism and agricultural sectors offer employment opportunities. The dynamics of tourism revenue as well as the balanced supply of the primary production sector have been offset by all the negative effects of implementing a high tax policy.

## 3 Methodology and Results

In order to proceed to our research, we chose to use the following triplex-variable VAR model in order to analyze the causal relationship between the variables of our model:

$$\text{``}\mathrm{GDP} = \mathrm{f}\,(\mathrm{Tour}, \mathrm{M3}, \mathrm{Constr})\text{''} \tag{1}$$

GDP is the Gross Domestic Product, Tour is the net value added generated by tourism receipts, Constr is the Construction of buildings, houses in general and the M3 (broad money) indicator includes M2 and marketable securities issued by monetary financial institutions. The model to be estimated is the following:

$$\ln\text{``}(GDP) = a_1 \ln\left(GDP_{tour}\right) + a_2 \ln\left(GDP_{m3}\right) + a_3 \ln\left(GDP_{constr}\right)\text{''} \tag{2}$$

**Table 1** Long-run relationship of our model

| | Dependent variable ΔLGDP tGR | | | |
|---|---|---|---|---|
| | Regressor | Coefficient | St. error | Prob. |
| Greece | $Ec_m$GRE(t − 1) | −0.036 | 0.016 | 0.031 |
| | $Ec_t$GRE(t − 1) = ΔLGDP tGRE − (−0.0009*ΔLConstr tGRE − 0.2352*ΔLM3 tGRE − 0.46340*ΔLTOUR-tGRE) | | | |

where EC is the error correction term, μ is a 3 × 1 vector of white noise errors

Having validated the existence of Cointegration, we estimate the Unrestricted Error Correction Model (UECM) and if we take into account the equation of the Vector Error Correction Model, our equation can be formulated as:

$$\text{“}\Delta U_t = A_0 + A(L)\Delta U_{t-1} + \delta EC_{t-1} + \mu_t\text{”} \tag{3}$$

According to our findings, we can strongly support that if we use Gross Domestic Product as the endogenous variable then we can conclude that the δ coefficient is statistically significant since the VAR system returns to us one Error correction term. According to the econometric theory, if the speed of adjustment is negative and statistically significant then long-run relationship with the endogenous variable is acceptable. In Table 1 we can observe the endogeneity of GDP and the other variables of our VAR model.

In general, we can conclude that the contribution of tourism to the economic development of Greece appears to play an important role, even in times during which the country's economy is in a prolonged economic recession. The construction sector contributes positively to economic growth but the intensity is less than that of the tourism industry (Spinthiropoulos et al. 2018a, b). VAR Model selection was needed in order to study the long-term relationship. Our priority was to draw safe conclusions and in order to achieve that we proceed to our analysis by using the VAR technique (we followed the VAR method). According to the results of Vector Authentication Estimate, the existence of the Fusion was confirmed. The long-term relationship between the variables exists because the ECT has the correct sign and is statically important. In economies such as Greece's, there is a long-term relationship and at the same time the absence of a short-term relationship between the variables examined by this study.

Continuing our research and in order to study the relationship between GDP in Greece, the net added value generated by agriculture, receipts from tourism (as a substitute for GDP generated by tourism) and receipts from taxes (goods, services, property, and net taxes) we use the revenue from different types of taxes expressed as a fraction of GDP and as a measure of the ability of Greece to increase the level of collecting money through taxation. The VAR model technique has the unique advantage of treating all variables as potentially endogenous:

Regressive (VAR) model:

**Table 2** Error correction model—long-run relationship

| | Dependent variable $\Delta LGDP_{tGR}$ | | | |
|---|---|---|---|---|
| | Regressor | Coefficient | St. error | Prob. |
| Greece | $Ecm_{GRE(t-1)}$ | −0.18787 | 0.172768 | 0.0283 |
| | $Ec_{tGRE(t-1)} = \Delta LGDP_{tGRE} - (0.0009*\Delta LGSTAXES_{tGRE} + 0.3752*\Delta LNTAXES_{tGRE} - 0.474330*\Delta LTOUR\text{-}_{tGRE} + 0.009*\Delta LPROPERTAXES_{tGRE} - 0.265635\ \Delta LAGRI_{tGRE})$ | | | |
| | $R^2 = 0.3966$ | | | |

$$\text{“}U = (GDP, GSTAXES, NTAXES, TOUR, PROPERTAXES, AGRI)\text{”} \quad (4)$$

where GDP is the real gross domestic product, GSTAXES is the tax on goods and services (i.e., is defined as all taxes levied on the production, extraction, sale, transfer, leasing or delivery of goods, and the rendering of services, or on the use of goods or permission to use goods or to perform activities).

The equation for economic growth in Greece can be expressed (after normalizing the cointegration vector), as:

$$\text{“} \ln GDP_t = \beta_1 \ln GSTAXES_t + \beta_2 \ln NTAXES_t + \beta_3 \ln TOUR_t + \beta_4 \ln PROPERTAXES_t + \beta_5 \ln AGRI_t \text{”} \quad (5)$$

The VAR model is necessary to introduce the economic growth as an equation which is:

$$\ln \text{“}GDP_t a_0 + \sum a_{1j} \Delta \ln GSTAXES_{t-j} + \sum a_{2j} \Delta NTAXES_{t-j} + \sum a_{3j} \Delta \ln TOUR_{t-j} + \sum a_{4j} \Delta \ln PROPERTAXES_{t-1} + \sum a_{5j} \Delta \ln AGRI_{t-1} + \delta EC_{t-1} + e_t \text{”} \quad (6)$$

where $EC_{t-1}$ represents the deviation from equilibrium in period t and the coefficient δ represents the response of the dependent variable in each period to departures from equilibrium.

According to Table 2, tourism receipts, agriculture value added to GDP, and taxes affect economic growth in the long run. This means that we have long-run causality relationships among the variables of our model. Additionally, the Error Correction Term (ECT) has the expected sign (negative and statistically significant) indicating that any deviation from the long-run equilibrium between variables is corrected with an annual rate of about 18.78%. Undeniably this indicates the existence of Cointegration of the variables studied (Spinthiropoulos et al. 2018a, b).

## 4 Conclusions

Tourism is one of the fastest growing markets in the world. Nevertheless, the primary sector is also a major contributor to the growth of GDP for many countries. Both can be very important for a country, particularly during a period of economic recession as the tourism industry and the primary sector may contribute to falling unemployment and accelerate growth.

Measuring the tourism and primary sector's contribution to GDP, based on the theory and relevant literature, the analysis attempted to examine the presence of linear relationships between them. Based on our findings, GDP is affected by tourism GDP (in the long and short term) whereas the reverse relationship is only valid in the long term.

The Greek economy seemed to be unprepared for an economic crisis. The prolonged economic downturn, lack of capital resources, and rigorous capital controls have resulted in a dramatic decline in Greek GDP. The tourism industry plays a key role in the Greek economy's economic development. The tourism accommodation, construction, and money supply industry in particular tend to have a positive relationship with Greece's GDP. In other words, the contribution of tourism to the country's economic growth seems to play an essential role even in times of prolonged economic recession in the country's economy.

There is no question that the tourism industry plays an essential role in Greece's economic recovery. In general, the service sector and tourism in particular are highly developed and offer job opportunities. Following the survey, we examined the role of taxes in Greece's GDP and the impact of high taxation on economic activity. Based on our results, GDP has been positively affected by tourism and agriculture GDP and negatively affected by all kinds of taxes used in our model. It is a fact that the high level of taxation has not stopped the influx of millions of tourists from abroad and foreign currency revenues have strengthened the Greek economy over the years of severe economic recession.

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# Immigration and Economic Growth: The Case of Greece

**Anastasia Blouchoutzi and Christos Nikas**

**Abstract** In the aftermath of the recent economic and migration crisis, Greece was found facing questions such as whether immigration is advantageous for the economy of the country or whether the benefits of immigration outweigh its economic cost. During a recession, immigration usually attracts general attention due to the competition for scarce job vacancies and social provisions. Consequently, countries tend to respond reactively by adopting more restrictive immigration policies. However, the economically rational response to the immigrant inflows is the effective labor market integration, which eventually leads to a successful social inclusion of the immigrants. This chapter focuses on displaying the potential gains of immigration for Greece by presenting the "immigration surplus," that is the economic benefits due to immigration. A neoclassical growth model is used assuming a competitive, market-clearing framework to measure the impact of immigrants in natives' earnings from 2001 to 2018. Moreover, the chapter aims at exploring whether there is a long-run relationship between immigration and growth in Greece and estimate it using the dynamic least squares method.

## 1 Introduction

Greece, being at the crossroads of Europe, Asia, and Africa, started attracting immigrants in the late 1980s and the early 1990s. Immigrants' proportion to the total population was increasing gradually since the outburst of the financial crisis in 2009, as it is presented in Table 1, with the ratio of immigrants to the total labor force being higher than their ratio to the total population. Therefore, it could be suggested that immigrants have contributed to GDP growth in Greece during the last decades.

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**Table 1** Population in Greece by citizenship (thousands)

| Year | Total population | Natives |
|---|---|---|
| 1987 | 9714.50 | 9659.40 |
| 1988 | 9739.20 | 9672.40 |
| 1989 | 9752.80 | 9690.50 |
| 1990 | 9843.60 | 9777.00 |
| 1991 | 9919.00 | 9839.80 |
| 1992 | 9942.70 | 9838.70 |
| 1993 | 10,118.20 | 10,002.70 |
| 1994 | 10,206.00 | 10,080.90 |
| 1995 | 10,238.00 | 10,107.50 |
| 1996 | 10,254.30 | 10,120.90 |
| 1997 | 10,265.60 | 10,097.10 |
| 1998 | 10,389.60 | 10,095.20 |
| 1999 | 10,437.10 | 10,146.80 |
| 2000 | 10,471.90 | 10,176.30 |
| 2001 | 10,813.30 | 10,453.00 |
| 2002 | 10,852.10 | 10,416.10 |
| 2003 | 10,887.50 | 10,399.30 |
| 2004 | 10,925.40 | 10,361.30 |
| 2005 | 10,963.30 | 10,383.70 |
| 2006 | 10,999.10 | 10,424.90 |
| 2007 | 11,034.90 | 10,405.90 |
| 2008 | 11,059.40 | 10,346.80 |
| 2009 | 11,061.30 | 10,215.80 |
| 2010 | 11,028.80 | 10,188.10 |
| 2011 | 10,998.30 | 10,208.20 |
| 2012 | 10,967.20 | 10,202.90 |
| 2013 | 10,921.10 | 10,198.60 |
| 2014 | 10,880.50 | 10,181.20 |
| 2015 | 10,831.70 | 10,204.10 |
| 2016 | 10,783.20 | 10,221.10 |
| 2017 | 10,730.70 | 10,216.80 |
| 2018 | 10,673.40 | 10,178.80 |

Source: Hellenic Statistical Authority (2019)

The numbers reported in Table 1 refer to the legal immigrant population in Greece. One of the challenges of immigration for the Greek state though has been the large number of undocumented immigrants and their occupation in the informal sector of the economy which has expanded it to become one of the largest informal economies in Europe (Arango and Baldwin-Edwards 2014). Greek immigration policy reform followed the influx of illegal immigrants and immigration gradually became an issue of political debate. The majority of the immigrant population in Greece used to consist of Albanians according to the 2011 census of the Hellenic Statistical Authority and they were concentrated mostly in urban areas like the

capital city of Athens (Hellenic Statistical Authority 2011). Albanians massively left their country after the fall of the Communist bloc searching to improve their standards of living and find well-paid jobs. In fact, the target of the immigration policy reform launched in Greece in 1991 was the deportation of Albanians who had entered Greece illegally and the prevention of further illegal immigration (Manou et al. 2019).

It has been supported that initially immigrants had not been competitive to natives except from low-skilled sectors (Nikas and King 2005). On the contrary, a big part of the latent demand which was created in Greece by the rising living standards, the rigidities of the local labor market, and the EU-funded investments during the aforementioned time period was met by the immigrant population (Nikas and King 2005). As such, the gaps created due to the new needs and the mobility of the native labor force to upgraded job positions were covered by the immigrant inflows (Lyberaki 2008). Moreover, the labor supply shock created by low-paid immigrant workers helped family businesses and small traditional manufacturing units to be viable instead of closing despite the fact that, at the same time, it contributed to minimum modernization and innovation initiatives in manufacturing and industrial sectors in Greece (Triantafyllidou 2007).

Following the global financial crisis, Greece entered a period of deep recession. Furthermore, during the economic downturn, Greece was found in the front line of the refugee crisis which was triggered by the Syrian civil war. As a result, immigrants already integrated into the Greek labor market started to compete with the natives for the limited job places, while there were also the newcomers who entered the labor force searching for employment opportunities. During a recession, immigration usually attracts general attention due to the competition for scarce job vacancies and social provisions (Hatton 2014). Consequently, countries tend to respond reactively by adopting more restrictive immigration policies. However, the economically rational response to the immigrant inflows is the effective labor market integration, which eventually leads to a successful social inclusion of the immigrants (Zimmermann 2017).

The aim of this chapter is to elucidate the economic benefits of immigration in Greece and relate immigration with the economic growth. Toward this purpose, Borjas' formula (1995), implemented in the case of the United States to compute the amount of the immigration surplus, is utilized. The use of this calculation presumes an oversimplified economy which is actually not the case for Greece. Nevertheless, even the estimation of the upper bound of the amount of the national income accruing to the native population due to immigration could stimulate the assessment of the advantages of immigrants' presence in Greece, so as the appropriate immigration policies to be implemented in order to capitalize on it. Moreover, this chapter seeks to explore whether there is a long-run relationship between immigration and GDP growth using a dynamic ordinary least squares model with quarterly data from 2001 onward.

The rest of the chapter is divided into five parts. The following section gives a brief theoretical perspective on the impact of migration on the countries involved in the migration process. The review of the most relevant literature follows in order to

establish the framework in which this chapter contributes. The empirical part of the chapter is divided into two sections. The first section is dedicated to the description of Borjas' model and the estimation of the immigration surplus in Greece. Next, the econometric testing of the available data follows to search for the cointegration between immigration and GDP growth. Last but not least, the main conclusions of the chapter are produced.

## 2 A Theoretical Perspective on the Impact of Migration

The motives for the mobility of people vary from economic to political, environmental, or personal. For example, the low-income level, the low pay wages, the GDP decline, the harsh working conditions, and the level of unemployment usually induce migration outflows. Moreover, authoritarian regimes, conflicts, war, or climate change could also provoke emigration (Christodoulou and Nikas 2012). On the other hand, a high index of economic welfare, high salaries, labor demand, and loose immigration policy could attract immigrants toward a country (Christodoulou and Nikas 2012). It is definitely the age, the gender, and the origin of a migrant that defines his/her decision to migrate (Nikas and King 2005, p. 246; King and Vullnetari 2009, pp. 28–30). But other features such as education, foreign language qualification, working experience, family status, and human capital investment also play a role in the decision to migrate. Thus, migration is a constant challenge for the countries involved even if they are the source countries of the migrants, the transit countries in the migratory route, or the host countries.

Migration generates several positive and negative economic and social consequences for the migrants themselves and for the countries that send and host them. With regard to the country of the migrants' origin, there is a decrease in the unemployment rate due to the outflow of labor. There is also an increase in financial inflows in the form of migrant remittances and foreign direct investment. Remittances, apart from their use for consumption purposes, they are also a potential pool of savings and investment capital for future investment and capital formation (Nikas 1991). Knowledge diffusion, which helps narrowing the technological gap between the country of origin and the destination country, is another benefit of the migration process, which eventually results in the reduction of emigration and the increase of emigrants' repatriation in the long run (Dos Santos and Postel-Vinay 2003, p. 163). Along with the findings that positively relate past migration with business ownership (Kilic et al. 2007, p. 23) and the repatriation of migrants with the productivity level of the source country (Leon-Ledesma and Piracha 2004, p. 77), migration could be considered as a developmental tool. The question of whether migration leads to development and reduces poverty in the migrants' country of origin has actually caught the attention of the researchers. In the literature, there are studies favoring the growth potential of migration through certain channels like enhancing the asset positions and the productivity levels of poor households via migrants' remittances and overseas savings or the human capital accumulation of the return and the circular

migration (Kilic et al. 2007, pp. 2–3). However, there is a whole different issue concerning the effect of migration on the inequalities and the redistribution of income.

As far as the social outcomes of migration are concerned, there is much attention on the permanent phenomenon which deprives the country of origin of population growth, since the migrants are usually young and they belong to the country's labor force. The loss in human capital has been a controversial issue especially due to its long-run consequences (Christodoulou and Nikas 2012). Migration results in a considerable loss of labor force upon which the sending country invested. However, as it was mentioned above, this could also work vice-versa, in the way that part of the sending country's unskilled labor force finds the opportunity to acquire qualifications and useful knowledge abroad and affects their home country through imitation and knowledge diffusion (Dos Santos and Postel-Vinay 2003, pp. 162–163). In general, the migration cost, the adaptation difficulties, the racial and social racism migrants face, make the policymakers skeptical on the appropriate measures that could relieve the migrant population (Christodoulou and Nikas 2012).

The migration process affects the labor supply and consequently the levels of employment and wages in the destination country as well. Migrants' host countries benefit as they cover their gaps with qualified or unskilled labor (Zhao and Kondoh 2007, p. 347) and improve their growth rates. The increase in the labor supply helps covering the shortages in the labor market of the host countries relieving it from the upward pressure on the wages. The employment of immigrants in job positions with low skills can exert negative pressure on the wages of the host country, but it could also lead the locals in better positions pushing in this way wages to rise (Franz et al. 1994, p. 224). It is the immigrants' skill composition that defines the wage adjustments and the gains and the losses for the natives. Immigration affects, for example, the wages of the native labor force with different skill composition to the immigrants', under the assumption of a perfectly elastic capital (National Academies of Sciences, Engineering, and Medicine 2017, pp. 165–196). When assuming for an imperfect elasticity of capital, the capital owners are going to receive some of the gains of immigration. According to the Solow model, a permanent migration flow will reduce per capita income in the short run, when immigrants are less skilled than the natives. If, on the other hand, the supply shock comes from highly qualified workers, then it could trigger long-term economic growth (National Academies of Sciences, Engineering, and Medicine 2017, pp. 165–196). Changes in the output mix of the economy or a technology modification are alternative mechanisms of adjustment to the labor supply shock in the migrants' host country (Dustmann et al. 2008).

## 3 Literature Review

The relationship between immigration and growth in migrants' host countries has challenged the researchers, enriching the literature with several case studies based on various approaches which lead to diverse results, offering still plenty of evidence to build on and stimulating further analysis. Boubtane et al. (2013) using a panel VAR for 22 OECD countries found that immigration positively affects GDP per capita and is affected by the host country's economic conditions. In 2016, Boubtane et al. (2016) reaffirmed with their research the positive impact of the migrant's human capital on the GDP per capita and the high growth impact of immigration even in the case of host countries with nonselective migration policies. On the contrary, Bashier and Siam (2014), using the Fully Modified Ordinary Least Squares approach in a Cobb–Douglas production function economic model for Jordan, ended up with a positive but insignificant impact of immigration on economic growth.

Morley (2006), in his study on the cases of Australia, Canada, and USA, used an ARDL bounds testing approach to examine the causality between economic growth and immigration and much as he found a long-run causality running from the per capita GDP toward immigration, there was no evidence proving the relationship the other way round. Feridun's results in the case of Finland provided no evidence of causality between the two variables (Feridun 2004). In the research of Gonzalez-Gomez and Giraldez (2011), even the results of the causality testing between immigration and growth for two traditional destination countries for immigrants in Europe, Germany, and Switzerland, have been contradictory. In the case of Germany, the per head number of foreigners causes economic growth, while in Switzerland it does not.

As regards the influential work of Borjas and his concept of "immigration surplus," there is plenty of research built on it, like Altonji and Card (1991) Peri and Ottaviano (2005), Drinkwater et al. (2007), and Ben-Gad (2008) pointing out various aspects of the impact of immigration on the labor market of the host country.

There are several papers searching for the impact of immigration on native workers in the case of Greece too. Chassamboulli and Palivos (2013) allowed for skill heterogeneity and differential unemployment income between immigrants and natives and supported that skilled natives gain from immigration in terms of employment and wages. Chletsos and Roupakias (2012) studied the direction of causality between migration and two macroeconomic variables, real GDP and unemployment, and though they detected that GDP growth as well as unemployment Granger cause migration, there was no evidence for the reverse causality. Dritsakis (2008) also examined the causal relationship between migration and economic growth, revealing a long run bidirectional causality. Tzougas (2013) reaffirmed the long-run bidirectional causality between immigration and GDP per capita.

Relevant literature about the "immigration surplus" for other European countries has been available as well. Amuedo-Dorantes and De la Rica (2013), assessing the impact of immigration in Spain, showed that the amount of the immigrant surplus is larger when considering the imperfect substitutability between immigrant and native

workers. The benefits of migration are pointed out for the Visegrad group of countries by the empirical research of Bilan and Strielkowski (2016). Kim et al. (2010) focusing on the UK labor market recommended that migration increases the world growth rate except for the case of unskilled migration.

In the aforementioned framework, this chapter searches for the cointegration between immigration and GDP growth in the case of Greece following the Stock and Watson (1993) DOLS approach, which has been found to be superior to other long-run model estimators, using available quarterly data from 2001 to 2018. Moreover, part of the empirical research is dedicated to estimate the immigration surplus in Greece using longitudinal data and following Borjas' calculation formula.

## 4 Immigration Surplus in Greece

Borjas (1995) tried to shed light on the benefits that natives receive due to immigration in the USA and established that the short-run immigration surplus is on the order of 0.1% of the US GDP. Emphasizing on the production complementarities between immigrant workers and other factors of production, he provided evidence that natives do benefit from immigration. For the purpose of Borjas' study, the following assumptions have been made:

- A single consumption good is produced.
- The elasticities of capital and labor supply is 0.
- All workers are substitutes in production.
- Natives own the capital.
- The negative impact of immigration on the wage is spread over the entire economy.
- There is no structural unemployment.

Borjas' research led to the following suggestions:

- The complementarities that exist between capital and labor produce the immigration surplus through the fall in the native wage.
- Apart from the efficiency gains, there are distributional issues arising due to the transfer of wealth away from workers.
- A small immigration surplus could mean small or even negative economic benefits due to the fiscal cost of immigration which should be taken into account when defining the optimal size and skill composition of immigrant flow.

The calculation formula for the short-run immigration surplus as a fraction of national income based on the aforementioned simple economic model which Borjas used is as follows (Eq. 1):

$$\text{“}\Delta Qn/Q = -½ * s * e * m^{2}\text{”} \tag{1}$$

where

s = labor’s share of national income
e = elasticity of factor price for labor
m = foreign-born fraction of the labor force

In the case of Greece, half of the total national income is paid as employee compensation. As for the elasticity of factor price for labor, assuming a linear homogeneous Cobb–Douglas production function, it is derived as follows: $e = s - 1$ (or else e = capital’s share of income). Labor force, in this study, refers to the fraction of the working age population 15–64 years old. The data are available from the ILOSTAT (2019) and Eurostat (2019) webpages.

Following Borjas’ calculations, we intend to create longitudinal immigration surplus data for Greece from 2001 to 2018. The experience of Greece as a destination country for migrants originated from the Balkans and the Eastern European countries and as a transit country for migrants originated from the MENA countries could provide us with quantitative data to describe whether natives benefit from immigration. It should be noted that the aforementioned methodology is a static one, used for small temporary immigrant inflows. Therefore, it does not account for the immigrant stock and the adjustment of the capital over the years. However, the implementation of such a simple model, though it may not capture the exact quantitative effect of immigration in Greece but rather the upper limits of it, it could still provide us with useful policy suggestions on the benefits of immigration on growth.

Using longitudinal data for Greece from 2001 to 2018, this study suggests that the immigration surplus in Greece, as depicted in Table 2 varies between 0.02 and 0.12% of GDP. Though it seems as a small amount, considering the absolute values it is between 35 and 283 million euros. It peaked in 2009–2010, when the labor share of income and the foreign-born fraction of the workforce in the country received their largest values. This is attributable to the fact that during these years, in the aftermath of the global financial crisis and the beginning of the Greek government-debt crisis, the total active labor force in Greece started to decrease due to the flea of many Greek emigrants abroad to search for better job opportunities.

This “textbook” model, as Borjas mentions it (2006, p. 10), illustrates the plausible dynamics of immigration in the case of the Greek labor market. Such an outcome, no matter how small it seems relative to the overall economy, it is enlightening of the potentials of immigration in Greece and crucial for the planning of a more immigration friendly policy.

**Table 2** Immigration surplus in Greece

| Year | Immigration surplus % GDP | Immigration surplus (€) |
|---|---|---|
| 2001 | 0.02 | 35,007,000.69 |
| 2002 | 0.04 | 59,382,056.10 |
| 2003 | 0.04 | 77,009,449.29 |
| 2004 | 0.05 | 101,961,359.57 |
| 2005 | 0.06 | 116,348,839.86 |
| 2006 | 0.06 | 121,097,226.24 |
| 2007 | 0.06 | 150,913,491.26 |
| 2008 | 0.08 | 204,018,257.33 |
| 2009 | 0.12 | 283,459,965.86 |
| 2010 | 0.12 | 270,377,749.23 |
| 2011 | 0.11 | 219,838,908.82 |
| 2012 | 0.10 | 184,640,804.59 |
| 2013 | 0.09 | 162,637,650.85 |
| 2014 | 0.09 | 157,054,172.95 |
| 2015 | 0.07 | 119,858,750.81 |
| 2016 | 0.06 | 101,182,734.99 |
| 2017 | 0.05 | 85,434,072.08 |
| 2018 | 0.04 | 79,653,033.04 |

Source: Author's calculations

## 5 The Relationship Between Immigration and Economic Growth

For the purpose of defining the relationship between immigrant inflows in Greece and GDP growth, the generalized Cobb–Douglas type production function presented below (Eq. 2) will be utilized to capture the contribution of the immigrant labor force in the gross domestic output as follows:

$$\text{“}Y = b\, K^{a1} Ln^{a2} Lf^{a3}\text{”} \quad (2)$$

where

Y = output
K = capital
Ln = native labor force
Lf = foreign labor force
b = efficiency parameter, a1, a2, a3 = elasticity parameters

Quarterly data from 2001 to 2018 have been used in logarithms. The economic variables are the real gross domestic product (Y = GDP), the gross fixed capital formation (K = GFCF), the native labor force (Ln = NAT), and the foreign labor force (Lf = FOR). The data are available from the Hellenic Statistical Authority (2019). The main concern of this chapter is to verify whether there is a long-run

**Table 3** Descriptive statistics

| | GDP | FOR | NAT | GFCF |
|---|---|---|---|---|
| Mean | 5.28E+10 | 355,873.6 | 4,521,168.0 | 9.42E_09 |
| Median | 5.16E+10 | 338,150.0 | 4,514,050.0 | 1.05E+10 |
| Maximum | 6.33E+10 | 509,800.0 | 4,653,400.0 | 1.75E+10 |
| Minimum | 4.56E+10 | 189,500.0 | 4,395,200.0 | 4.38E+09 |
| Std. dev. | 6.04E+09 | 79,658.57 | 69,756.56 | 3.57E+09 |
| Skewness | 0.338481 | 0.082595 | 0.202710 | 0.154178 |
| Kurtosis | 1.601212 | 2.241411 | 2.026063 | 1.900784 |
| Jarque–Bera | 7.244651 | 1.808234 | 3.338755 | 3.910077 |
| Probability | 0.026720 | 0.404899 | 0.188364 | 0.141559 |
| Sum | 3.80E+12 | 25,622,900 | 3.26E+08 | 6.78E+11 |
| Sum S. dev. | 2.59E+21 | 4.51E+11 | 3.45E+11 | 9.04E+20 |
| Observations | 72 | 72 | 72 | 72 |

**Table 4** Unit root test

| Variables | Phillips–Perron *t*-test statistic | Test critical value 5% level |
|---|---|---|
| LGDP | −0.958620 | −2.902953 |
| ΔLGDP | −7.083470 | −2.903566 |
| LFOR | −2.548438 | −2.902953 |
| ΔLFOR | −6.186378 | −2.903566 |
| LNAT | −0.959146 | −2.902953 |
| ΔLNAT | −6.734211 | −2.903566 |
| LGFCF | −1.493730 | −2.902953 |
| ΔLGFCF | −16.06225 | −2.903566 |

relationship between immigration and economic growth and estimate it with the DOLS method which includes lagged and led values in the change of the regressors to deal with simultaneity and small sample size issues.

In Table 3 the descriptive statistics of the series are depicted. The standard deviation of the foreign labor force series is higher than that of the native labor force while as it was expected the mean of the latter is higher than the mean of the former. Skewness is around 0 while kurtosis is around 2. The Jarque–Bera test indicates a normal distribution of the series except from the GDP series for which the null hypothesis of a normal distribution is rejected at the 5% significance level but not for the 1%.

The first part of the analysis includes the stationarity tests to avoid spurious regression problems. Table 4 presents the results of the Phillips–Perron unit root test (Phillips and Perron 1988) for the presence of a unit root in the time series. Since all the variables are integrated of order (I) the appropriate lag length of the model is computed and the Johansen cointegration test (Johansen and Juselius 1990) is conducted to determine the number of cointegrating vectors.

Before proceeding with the Johansen cointegration test which is subject to the sensitivity of the lag length, the VAR lag order selection criteria have been used.

**Table 5** Lag order selection criteria

| Lag | LogL | LR | FPE | AIC | SC | HQ |
|---|---|---|---|---|---|---|
| 0 | 365.5154 | NA | 2.83e-10 | −10.63281 | −10.50225 | −10.58107 |
| 1 | 669.2709 | 562.8411 | 5.99e-14 | −19.09620 | −18.44341[a] | −18.83754[a] |
| 2 | 682.6661 | 23.24462 | 6.50e-14 | −19.01959 | −17.84456 | −18.55401 |
| 3 | 701.6691 | 30.74020 | 6.02e-14 | −19.10792 | −17.41064 | −18.43540 |
| 4 | 724.1175 | 33.67251[a] | 5.11e-14[a] | −19.29757[a] | −17.07806 | −18.41814 |

[a]Value indicates lag order selected by the criterion

**Table 6** Results of Johansen cointegration test

| Trace test | | | | |
|---|---|---|---|---|
| Hypothesized number of CE(s) | Eigenvalue | Trace statistic | 0.05 critical value | Prob. |
| None* | 0.436620 | 62.37959 | 47.8561 | 0.0012 |
| At most 1 | 0.197463 | 23.36110 | 29.79707 | 0.2288 |
| At most 2 | 0.114178 | 8.402647 | 15.49471 | 0.4234 |
| At most 3 | 0.002326 | 0.158359 | 3.841466 | 0.6907 |
| Maximum eigenvalue test | | | | |
| Hypothesized number of CE(s) | Eigenvalue | Trace statistic | 0.05 critical value | Prob. |
| None* | 0.436620 | 39.01849 | 27.58434 | 0.0011 |
| At most 1 | 0.197463 | 14.95845 | 21.13162 | 0.2918 |
| At most 2 | 0.114178 | 8.244288 | 14.26460 | 0.3544 |
| At most 3 | 0.002326 | 0.158359 | 3.841466 | 0.6907 |

*Denotes rejection of the hypothesis at the 0.05 value, MacKinnon–Haug–Michelis *p*-values (MacKinnon et al. 1999)

**Table 7** Estimated DOLS model

| Variable | Coefficient | Std. error | *t*-statistic | Prob. |
|---|---|---|---|---|
| LFOR | 0.153852 | 0.019631 | 7.836987 | 0.0000 |
| LNAT | 3.036740 | 0.555489 | 5.466791 | 0.0000 |
| LGFCF | 0.167097 | 0.026708 | 6.256509 | 0.0000 |
| C | −27.64136 | 8.011807 | −3.450078 | 0.0011 |

Included observations = 69 after adjustments, $R^2$ = 0.981038, Automatic leads and lags specification: 2 leads, 0 lags based on AIC, Long-run variance estimate: Bartlett kernel, Newey–West fixed bandwidth = 4.0000 potentials

Two of the criteria suggest one optimum lag and the rest of them favor four lags for the model, as it is portrayed in Table 5. However, the diagnostics for the model with four lags perform better.

The Johansen cointegration trace test indicates one cointegrating vector at the 0.05% significance level as also indicated by the maximum eigenvalue. The results of the Johansen tests are presented in Table 6.

Having established the existence of one cointegrating vector, the DOLS approach is utilized to establish the long-run relationship between the variables which is presented in Table 7. The maximum lag length is set up at four following the Akaike criterion.

The long–run coefficient of the immigrant labor force is indicative of a positive and significant ($p$-value = 0.0000) relationship. The results of the DOLS estimator portray that an increase of 1% in the immigrant labor force boosts GDP growth by 0.15% providing further evidence in the existing literature that immigration could be beneficial for the economic growth of the host country. The largest coefficient in the regression is the native labor force's estimator which is indicative of a ratio relationship between economic growth and native labor force in the order of 1:3 confirming the labor-intensive production in Greece. With regard to the capital's coefficient in the regression, it is smaller than the native labor's and larger than the foreign labor's ones. Still, it is positive and significant as expected.

## 6 Conclusion

In a period when immigration in Europe has been questioned, this chapter unveils the relationship of immigration and growth for Greece. Apart from the immigrant flows in the country, which peaked in 2015, Greece has also faced a deep economic recession that altered its labor market. However, the economically rational response toward immigration is the successful labor market integration.

This chapter provides evidence that immigration could be beneficial for the native population in Greece following a targeted immigration policy. The results of this study offer indication that the immigration surplus in Greece, that is the economic benefits from immigration, has varied between 0.02 and 0.12% of GDP, which could prove a valuable contribution to the natives' earnings in a period of recovering from a deep economic recession. Moreover, the results of the econometric tests illustrate a long-run positive relationship between immigration and growth which provides further evidence of the immigrants' contribution in the GDP growth in Greece. In particular, the findings of the empirical testing suggest that a 10% increase in the immigrant labor force could increase the output by 1.5%. Considering that the projections of the Bank of Greece for the GDP growth in the next years do not exceed 2%, it could easily be derived that proper selective immigration and effective integration policies that would capitalize on the immigrants' human capital could strengthen the developmental potentials of the Greek economy.

Hence, the importance of a targeted immigration and integration policy has become even more evident. In a period of recovery from a deep recession and restructuring of the Greek economy which has lost a considerable part of the young and highly skilled native labor force due to the economic crisis, the enlightenment of the potentials of the immigrants' presence in Greece is a first step toward their effective integration in the labor market and their social inclusion in the Greek society.

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