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**Research Report**

## Harnessing FDI for innovation and green growth in the EU: Some evidence-based policy recommendations

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# **Harnessing FDI for innovation and green growth in the EU:**

## **Some evidence-based policy recommendations**

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Francesca Guadagno, Javier Flórez Mendoza,  
Francesca Micocci and Armando Rungi**





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# Abstract

Foreign direct investment (FDI) has become a driver of growth in both developed and developing countries, as it enables the transfer of know-how and advanced technologies to host economies. This policy note discusses how FDI can effectively support innovation and green growth within the European Union (EU). It focuses on the role of regulatory harmonisation and technological alignment as factors that can significantly influence the location decisions and effectiveness of FDI. Similarly, as spill-overs from foreign affiliates substantially enhance local innovation capabilities, particularly in green technologies, we argue in favour of policies enhancing domestic absorptive capacity and of policy mechanisms that can systematically integrate sustainability criteria into FDI screening processes. Aligning investment policies with regional technological strengths and green transition goals will enable the EU to leverage FDI strategically for sustainable economic growth and climate resilience.

**Keywords:** FDI, regulatory distance in NTMs, technological proximity, environmental technology, regional spill-overs

**JEL classification:** F23, L23, O24, O33, O34, R58, Q55



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# Harnessing FDI for innovation and green growth in the EU: Some evidence-based policy recommendations

## 1. INTRODUCTION

Foreign direct investment (FDI) is seen as an engine for growth in developed and developing countries alike. A key part of this is that multinational firms (MNEs) often define the forefront of technology. In addition to making them among the most productive firms, this also enables them to serve as a catalyst for growth for domestic companies, for example, by acting as a supply chain conduit to the global market. In general, it is well acknowledged that MNEs' technology can spill over to local firms, thus enhancing local productivity and employment.

Against the previous background, nations have long used tax and trade policy to attract foreign firms. As the role of MNEs' technological advantage becomes ever more important, this suggests that tax and trade policy may need to be joined by strategic innovation policy. This implies not only maximising the spill-overs generated by hosting foreign firms, but also attracting them in the first place. And when specific goals are desired, such as meeting environmental targets, favouring the attraction of MNEs that are specialised in specific technologies can help in reaching the targets.

This policy note summarises the results from three intertwined research projects seeking to provide a step forward in our understanding of the interaction of MNEs, local performance and innovation. By combining firm-level data of MNEs and domestic firms with patent information at the most disaggregated level, our projects provide a complementary set of results that paint a more nuanced picture of how MNEs and local firms interact in the technological space.

In broad strokes, three primary results are found. In the first project, we find that FDI is attracted to regions that innovate in the same technological areas as an MNE subsidiary does, but not those in which a parent MNE does (i.e. a given parent MNE seems to seek out locations that have already proven fertile in the technological fields in which its subsidiary should specialise). Thus, local technology drives FDI. The second project shifts the focus to local firms, finding that their employment and labour productivity can improve when MNEs enter their country. This, however, is primarily found with local firms that are themselves innovators. Thus, FDI drives technology so long as there are locals with the capacity to absorb the latest innovations embodied by the MNEs. An important factor here is that this relationship can be found not only for the technology of the local MNE affiliate, but also for the parent firm. This suggests that hosting FDI provides access to the global technological landscape. Finally, the third study shows that exposure to the MNE parent's global green innovation may well increase local green patenting. Although MNEs strive to protect their intellectual property (IP) regardless of where this is generated, proximity of local subsidiaries to their subsidiaries facilitates technology spill-overs. In this way, MNEs and their corporate perimeters across national borders act as conduits for knowledge diffusion.

Taken together, these three takeaways – local innovation attracts FDI, innovative MNEs improve the performance of innovative locals, and local MNEs' affiliates act as an access point to the MNEs' global innovative activities – suggests that governments may well wish to use investment promotion to achieve their objectives. In particular, since a parent MNE is attracted to regions with a comparative advantage in the key technological areas in which it itself is not specialised but intends to become specialised through its subsidiary, this suggests that promoting domestic innovation in strategic areas can help attract FDI. Further, by developing those capabilities among locals, this can help to maximise the domestic gains from hosting investment.

However, this does not suggest that trade policy should be ignored. In fact, the results across the working papers show that trade barriers and, in particular, divergence in sanitary and phytosanitary (SPS) regulations and technical barriers to trade (TBTs) can both impede inbound investment and limit local expansion. Instead, these results provide new, micro-level insights suggesting that to gain the most from the expanding dominance of MNEs, a holistic policy approach that combines trade, regulatory and innovation policy may be most effective in both gaining access to cutting-edge technology by inbound affiliates and their global firm network and in setting the stage to maximise the local benefits from those new connections.

The remainder of this policy note is structured as follows: Section 2 discusses the main findings of the three respective papers. Section 3 provides concluding remarks and outlines the policy recommendations.

## 2. THE DETERMINANTS AND IMPACT OF FDI IN THE EU

This policy note builds on the findings of a three-part research project that investigates how FDI can be steered to support the EU's climate and innovation agendas. Using a rich, firm-level dataset that combines information on firm ownership status, patenting activity, sectoral trade regulations and regional innovation capacity,<sup>1</sup> the project aims to inform policy makers on how to best align FDI strategies with the EU's long-term economic and environmental objectives. The project comprises three interlinked papers. The first paper (Castelli et al., 2025) identifies the determinants of FDI at the regional, sectoral and firm levels within the EU, with a focus on the roles of regulatory distance and technological proximity. The second paper (Davies et al., 2025) assesses the impact of FDI on domestic employment and productivity, examining the extent to which technological spill-overs take place. Finally, the third paper (Micocci et al., 2025) focuses on the diffusion of green technologies, analysing how foreign ownership influences the innovation dynamics of domestic firms. Building on the analytical insights of these three papers, this policy note provides concrete policy recommendations on the role of FDI in advancing the EU's innovation and green goals in line with the United Nations' Sustainable Development Goals (SDGs), the Paris Agreement, and the recent turn in the EU's agenda towards competitiveness and decarbonisation. The empirical results of these three papers are briefly presented below.

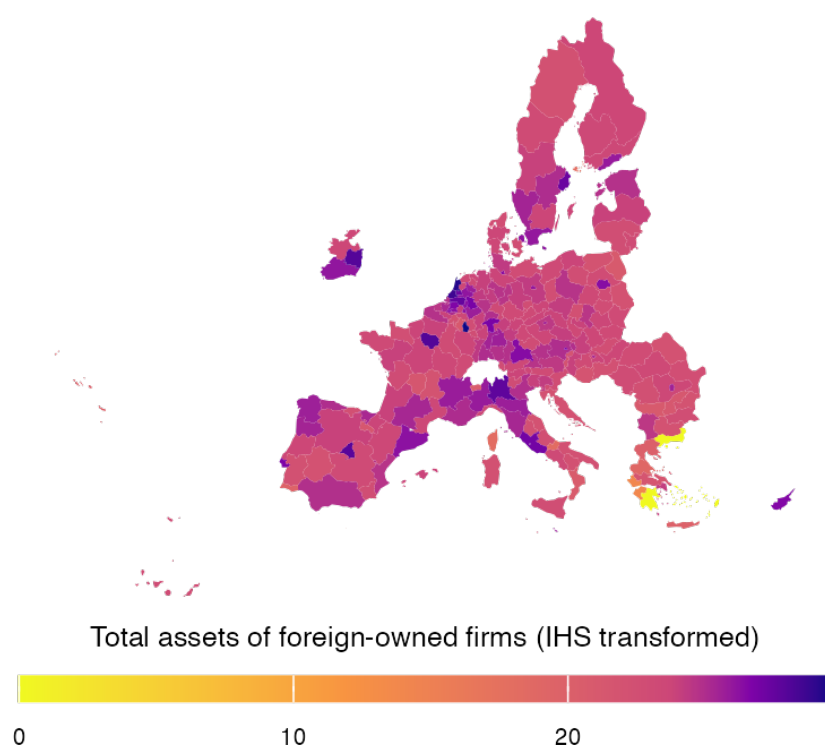
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<sup>1</sup> The project merges the Orbis, Orbis Crossborder Investment and Orbis Intellectual Property databases (Moody's Bureau van Dijk) and constructs a panel dataset covering foreign-owned subsidiaries of both EU and non-EU MNEs located in the EU.

## 2.1. Drivers of FDI in the EU: regulatory distance and revealed technological advantage (WP1)

In the first working paper (WP1) of the research project, we analyse the factors that determine FDI in foreign-owned subsidiaries located in the EU. The main focus is on the total assets of these subsidiaries, whose regional distribution across the EU is illustrated in Figure 1.

**Figure 1 / Regional distribution of total assets of foreign-owned firms**



Note: This figure illustrates the NUTS 2-level distribution of total assets of foreign-owned firms across the EU. The value depicted represents the inverse hyperbolic sine (IHS) transformation of the regional sum of total assets averaged over the 2013-2018 period.

The determinants of FDI have long been a subject of scholarly and policy interest. Classical drivers include market size, labour costs, macroeconomic stability and infrastructure. However, in a knowledge-based economy, technological alignment and regulatory compatibility have become increasingly important. WP1 investigates how regulatory distance (RD) in non-tariff measures (NTMs) and revealed technological advantage (RTA) influence FDI patterns within the EU.

The estimation strategy employs a Poisson pseudo-maximum likelihood (PPML) model to regress subsidiary-level asset stocks on dyadic measures of regulatory and technological distance. The model controls for firm characteristics, multilateral resistance terms and other unobservable factors using multidimensional fixed effects.

While tariffs are imposed uniformly across EU member states (though varying by sector), NTMs may be imposed independently by each member state. This is mainly because the EU's single market allows for mutual recognition of regulations across member states, while harmonisation justifies regulations

imposed at the EU level. Regulatory distance is measured using the stated objectives of TBTs and SPS measures, as cited in the keywords of their World Trade Organization (WTO) notifications (see Cieřlik and Ghodsi 2024). Thus, if an EU member state or the EU imposes a TBT on products in a given sector with objectives that differ from those of a trading partner, RD in that sector will be greater than if both parties were to impose regulations with the same objectives.

The results show that RD discourages extra-EU FDI. Increasing divergence in TBT and SPS standards between host and home countries significantly reduces investment in foreign-owned subsidiaries. This effect is particularly pronounced in high-tech and highly regulated sectors, in which compliance costs are substantial.

Tariffs induce tariff-jumping motives for FDI. Higher tariffs are positively associated with FDI inflows from outside the EU, suggesting that MNEs establish local affiliates to circumvent import restrictions.

Technological alignment also supports FDI. Subsidiaries are more likely to locate in regions where local technological capacities (proxied by regional RTA in patent classes) align with their own innovation portfolios. Interestingly, parent companies tend to avoid regions in which their own technologies are already dominant, possibly due to concerns over market saturation or internal competition.

In conclusion, the findings of WP1 suggest that investment-attraction policies must go beyond financial incentives and address institutional and regulatory barriers. Regulatory harmonisation within the single market and convergence with key extra-EU partners could lower entry costs and attract more innovation-driven FDI. Furthermore, investment-promotion agencies should build capacity to assess technological complementarities at the regional level and use this information to target specific MNEs more effectively.

## 2.2. Innovation interactions: multinational spillovers and local absorptive capacity (WP2)

FDI is generally expected to generate productivity and employment spill-overs through channels such as technology transfer, increased competition and supply chain linkages with domestic firms. However, empirical evidence is often mixed. A key part of those conflicting results, however, seems to depend on *who* is connecting to MNEs and *how* they are doing so. Davies et al. (forthcoming) investigate these dynamics using firm-level data on employment, productivity and patenting across the EU.<sup>2</sup>

From this analysis, the data adds to the increasing body of evidence suggesting that local firms gain the most by connecting to MNEs that supply inputs to themselves (i.e. when the MNE is upstream to the local firms). This suggests that having access to high-quality, locally sourced (albeit foreign-owned) inputs benefits the economic performance of local firms. The evidence is less compelling, however, when the MNEs operate in the same industry as the domestic firm, potentially because such positive spill-overs are countered by competitive pressures created when a highly productive foreigner enters a domestic firm's market. Likewise, while there may be some positive employment effects when the new

<sup>2</sup> FDI is measured using both traditional indicators (e.g. the value and number of both investment projects and merger & acquisition (M&A) deals) and more innovative metrics (e.g. patents held by MNE affiliates and their parent companies). Local spill-overs are assessed by regressing domestic firm outcomes on measures of foreign affiliate activity in the same upstream and downstream sectors while distinguishing between horizontal and vertical linkages, following the framework of Javorcik (2020).

MNE is a customer of the local firm, such results are not especially robust. This may be the case if a subsidiary sources key inputs from its parent company. Thus, how a local firm connects to inbound investment is a key part of the puzzle.

Furthermore, these new estimates suggest that not all local firms benefit equally from exposure to MNEs. In particular, the estimates point to positive spill-overs primarily for local firms who themselves innovate. This is consistent with the concept of absorptive capacity, meaning that in order to take advantage of the innovations embodied in the MNE affiliate, a local firm must have the ability to adopt and adapt those ideas for itself. For example, gaining access to a technologically advanced input may mean little unless the local firm can itself advance its own abilities in response.

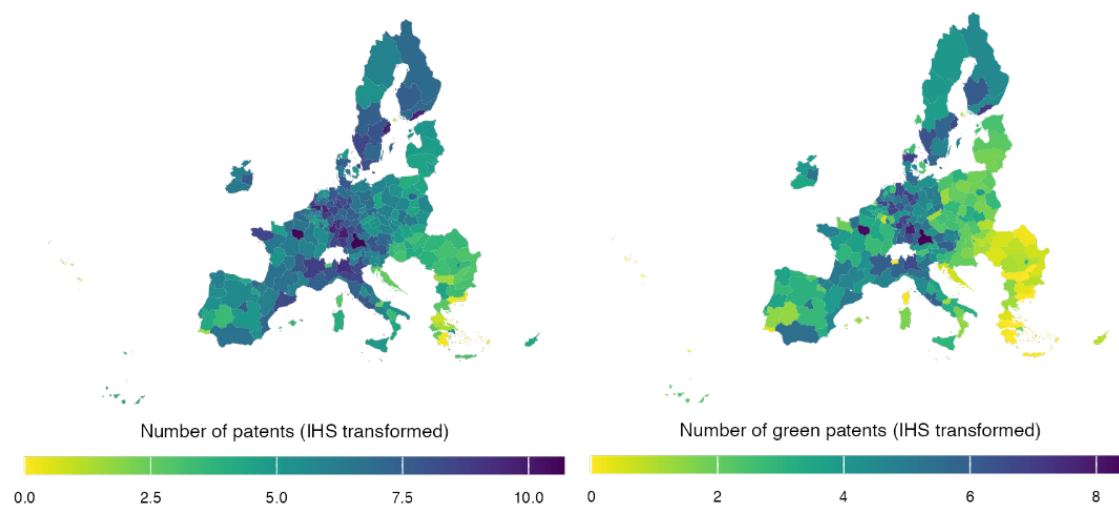
Hence, to enhance the benefits of FDI spill-overs, policies should support the innovation capacity of domestic firms, such as through research and development (R&D) subsidies, skills development and programmes to link MNE-suppliers to domestic firms. In addition, supply-chain mapping that illuminates key suppliers to local firms could help to identify sectors in which vertical linkages can be strengthened. Promoting co-location of MNEs and domestic suppliers may also yield substantial gains.

### **2.3. FDI and innovation dynamics: the role of foreign corporate groups and technological pathways in domestic green innovation (WP3)**

The EU's climate targets require the accelerated deployment of green technologies. FDI can facilitate this transition by introducing cleaner technologies, improving resource efficiency and raising environmental standards. The third working paper (WP3) explores the mechanisms through which green innovation diffuses from foreign MNEs to domestic firms.

Recent widespread environmental challenges – exacerbated by climate change – have led to numerous crises, civil wars and population displacements across many regions. These events highlight that many countries are not able to develop indigenous technologies to mitigate environmental threats. While adopting existing low-emission technologies is crucial for immediate mitigation, the development of new technologies to tackle environmental problems at their root could deliver more universal and long-term benefits. In this context, FDI plays a critical role by transferring knowledge, expertise and technology across national borders, potentially stimulating local innovation in green and environmental technologies.

WP3 uses the number of published patents as the primary indicator of successful innovation outcomes resulting from R&D activities. Figure 2 compares the regional distribution of the average annual number of total patents and green patents across EU regions. Notably, green patenting appears even more geographically concentrated than overall innovation, with a strong focus in regions of Western Europe. This pattern underscores the importance of location in shaping green innovation dynamics and provides a basis for assessing the diffusion of green technologies through FDI by analysing patenting activity in both foreign-owned and domestically owned firms across regional industries.

**Figure 2 / Regional distribution of the average annual number of patents published by firms**

Note: This figure shows the NUTS 2-level distribution of the average annual number of patents published by firms. The map on the left displays all patents, while the map on the right focuses exclusively on green patents. Values represent the inverse hyperbolic sine (IHS) transformation of the regional sum of annual firm-level patent counts averaged over the 2013-2018 period.

MNEs are the result of FDI, and they can exert a direct effect on innovation in two ways: via the establishment of foreign-owned subsidiaries and via involuntary knowledge spill-overs to domestic firms. To capture this dual impact, Work Package 3 (WP3) expands the analysis beyond conventional financial FDI indicators (e.g. M&As or greenfield investments) by incorporating data on the global patent portfolios of foreign MNEs. This approach aims to assess both the intensity of knowledge transfer and the innovation potential embedded in the global corporate structures of these enterprises.

Thanks to the richness of our data, we can consider patents held by: (i) foreign-owned subsidiaries in the EU, (ii) their parent company, and (iii) the broader corporate group, excluding the local affiliate. The empirical findings highlight the importance of group-level innovation. Green patenting by the parent group of foreign-owned affiliates in a given regional industry is positively associated with domestic green innovation. In contrast, innovation by the affiliate itself shows a weaker association with technological spill-over effects. This is consistent with evidence from WP2, which suggested that while linkages with MNEs may offer potential benefits to local firms, these can be offset by intensified competitive pressures in domestic markets. Foreign-owned subsidiaries, often active in the same product or technology space as local firms, may have strategic incentives to restrict knowledge diffusion and safeguard their innovations from domestic competitors. In contrast, innovation generated elsewhere within the MNE (i.e. outside the immediate scope of the local affiliate's activity) is more likely to spill over into the domestic market.

Importantly, the results reveal a divergence between green and non-green trajectories. If the foreign parent group is specialised in green technologies, positive spill-overs to domestic green innovation are more likely. However, FDI from MNEs focused on non-green sectors may crowd out local green efforts.

To strengthen green innovation, host-country policies must become more selective, as not all FDI is conducive to green growth. Screening mechanisms and investment agreements should incorporate sustainability criteria. Moreover, national and regional authorities should monitor the technological

trajectories of MNEs and prioritise those aligned with green innovation goals. Thus, public support and facilitation services (e.g. access to innovation funding, regulatory guidance or fast-track procedures) should prioritise investors that align with the EU's green technology priorities. Collaboration platforms and initiatives to share intellectual property (IP) may also be explored to facilitate broader technology diffusion and support the EU's green transition.

### 3. CONCLUSIONS AND POLICY RECOMMENDATIONS

The three main findings of this project can be synthesised as follows. First, MNEs seem to seek out locations that have already proved fertile in the technological fields in which they want their subsidiary to specialise. In other words, local technology drives FDI. Second, innovative local firms benefit from FDI in terms of both employment growth and labour productivity. Thus, FDI drives technology so long as there are firms with innovation capabilities. Third, FDI from MNEs with green innovations, especially those owned by the parent company, may well increase local green patenting. Thus, while FDI is attracted for spill-overs of specialised technologies from local industries to subsidiaries, the spill-overs from FDI subsidiaries to local industries are sourcing specialised technologies from the parent MNEs, providing a directional path of technological spill-overs. Taken together, these three takeaways suggests that governments should find the right mix of investment promotion, innovation, FDI and green policy instruments to achieve their objectives. Based on the combined insights from the three papers, we offer the following recommendations:

FDI can play a pivotal role in the EU's twin transitions (i.e. green and digital), but this will require a recalibration of policy priorities. It is no longer sufficient to increase the volume of FDI. Instead, policy makers must focus on who invests, in what and where. This project provides microeconomic evidence that regulatory compatibility, technological proximity and innovation capacity are crucial mediators of FDI's developmental impact.

Investment-promotion policies should favour the retention and attraction of MNEs that are highly innovative, from which one can expect technological spill-overs to domestic firms. Since highly innovative MNEs can be in any sector, we do not suggest picking any particular industry. The policy maker should understand what the complementarity of the competitive advantages of MNEs and local firms is.

Take, for example, the case of special economic zones (SEZs), which have been proposed as tax-free areas for investors to come and establish economic activities. We suggest introducing basic conditionality on the investors' innovation ability before commitment and not wasting tax capacity base for the sake of investment that would have happened in any case, including in absence of the SEZ. Regional technological specialisation in certain major EU cities has already served as a strong magnet for FDI in specific technologies, thereby reinforcing existing path dependencies. To ensure sustainable and equitable development across regions, regional policies should aim to attract FDI to a broader set of locations. Tax policies (e.g. patent boxes offering targeted tax incentives after granting a patent in that region) could be an effective tool for drawing innovative FDI to underrepresented regions.

The European Commission has recently recentred its economic policy debate on competitiveness, acknowledging the innovation and productivity gaps of the EU with other global players, most notably the United States. The quest for stronger competitiveness is tied to the EU's (ambitious) decarbonisation



agenda. Specifically, the decarbonisation-competitiveness plan, which was outlined in the Draghi Report (Draghi 2024) and revamped in the Competitiveness Compass and the Clean Industrial Deal, puts forward the idea that the EU could use the new production and technological opportunities created by the green transition to reindustrialise and regain its international and technological competitiveness (see also Guadagno et al. 2025).

In these policy discussions, the Commission has emphasised how foreign investment can be used strategically to maintain (or regain) international competitiveness. The Draghi Report (Draghi 2024) emphasised that FDI attraction can help to spur technological progress and the creation of high-quality jobs. This is particularly the case in the industries where the EU is interested in keeping production capacities, protecting jobs from unfair competition, and accessing advanced foreign technologies. At the same time, it is recognised that there should be enhanced coordination in, and a more strategic use of, FDI in Europe to avoid asymmetries and losses of negotiation power, particularly by small EU member states (see point below).

The EU and its member states must seek ways to reduce regulatory distance with external trading partners rather than pursuing deregulation as promoted by the agendas of new governments, such as the current US administration. In this regard, the EU should harmonise NTMs both within the single market and with major trade partners by introducing reciprocal NTMs aligned with policy objectives not previously addressed. This would create a level playing field for firms in partner countries, facilitating smoother supply chains and deeper economic integration through FDI. In this respect, the Draghi Report has emphasised how the lack of harmonisation and coordination at the EU level does not just harm the single market but also the smallest economies within the EU. Indeed, asymmetries arising from small member states negotiating with large foreign investors could lead to excessive concessions being extracted by foreign investors. Beyond the damages to the economy and the prospects for competitiveness and reindustrialisation, such uncoordinated negotiations might also be particularly concerning in the cases of sectors that are deemed strategic from a security perspective or in situations of geopolitical turmoil.

By strategically aligning FDI policies with regional innovation strengths and sustainability objectives, the EU can unlock new sources of growth, resilience and technological leadership in a rapidly changing global economy. Currently, the analysis of regional specialisations is at the basis of smart specialisation strategies. Since 2014, all EU countries and regions have designed and implemented smart specialisation strategies to concentrate their innovation and competitiveness efforts in a limited number of priority areas. Such priority areas should be linked to the region's present strengths (i.e. they should build on the existing knowledge base and capabilities) while at the same time creating new capabilities and sources of future competitive advantage (Foray et al. 2009). Various smart specialisation strategies, particularly in Central and Eastern Europe, acknowledge the role of FDI in promoting structural transformation. In these contexts, attracting high-quality FDI in high-tech industries and high-value-added activities (most notably R&D) remains a top priority to escape the middle-income trap, upgrade functionally (i.e. move towards higher-value-added activities of the value chain) and create new sources of economic growth (Ferrazzi et al. 2025; Zavorská et al. 2024).

At the same time, while innovative FDI can stimulate local innovation through knowledge spill-overs, it may also widen regional disparities. This is because regions differ in terms of their capacity to generate and absorb knowledge, which calls for differentiated innovation policies (Camagni and Capello 2013).

Regions with a strong knowledge base and rapid innovation processes – particularly in generative pre-trained transformers (GPTs) and applied sciences – offer the highest returns on R&D and naturally attract FDI from frontier sectors. Innovation policy in these regions should continue to support public investment in GPTs, foster transnational research collaboration and promote labour mobility. Conversely, regions with lower R&D intensity but strong human capital and creativity may benefit from policies that support new applications of existing technologies, paving the way for diversification and upgrading. In low-knowledge regions with untapped innovation potential, efforts to reduce institutional and social barriers while promoting knowledge diffusion should be encouraged alongside traditional FDI-attraction strategies, including targeted subcontracting with local firms, to enhance both technological and managerial spill-overs from MNEs. In other words, it is essential to tailor innovation policies that align with regional knowledge profiles to achieve inclusive, innovation-driven growth.

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