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Diplomatic relations and cross-border investments

in the European Union

Giacomo Damioli, Wildmer Daniel Gregori*

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Abstract

This study investigates the extent to which diplomatic relations affected merger and acquisition (M&A) activities in the European Union during the years 2001–2019. Implementing a gravity model, we find a positive relationship between diplomatic distance and M&A activities meaning that a worsening in diplomatic relations fosters inward M&As in Europe. The finding suggests that cross-border acquisitions to Europe could be a way for the investing firm to mitigate weak diplomatic relations' related issues, such as access to host markets' information and technology. It is confirmed especially when foreign investors target high-tech firms, are private (rather than state-owned) enterprises and buy larger shares of the target companies.

Keywords: Diplomatic relations, Cross-border M&A, EU, Foreign location choices, Gravity model.

JEL codes: F21, F52, G34, P16.

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1. Introduction

The discussion on whether Foreign Direct Investments (FDI) should be incentivised or limited is not close to an end (Bermejo et al., 2018; Gherghina et al., 2019). On the one side, FDI are a potential source of economic growth, especially for countries that promote greater financial freedom (Azman-Saini et al., 2010) and with well-developed financial markets (Alfaro et al., 2004). On the other side, public authorities may perceive FDI as a threat to their strategic interests and autonomy, especially in areas such as national security and high-technology industries. Therefore, the control over certain economic sectors plays a central role in governments' strategies, and acquisitions of national firms by foreign investors may be perceived as a threat (Heinemann, 2012).

The European Union (EU) has recently adopted a new regulation on FDI.¹ While the EU intends to remain an open market and welcome FDI, this openness is not unconditional, especially to protect internal security and economic sovereignty.² Therefore, the new FDI screening regulation aims to further increase the level of scrutiny over current and future foreign investments. It introduces a coordination mechanism among member states and the European Commission, also allowing the latter institution to issue non-binding opinions on upcoming FDI in the EU on the grounds of security and public order.³

The rise of worldwide political concerns related to foreign acquisitions in strategic sectors has been observed in different occasions. For instance, in May 2019 the United States banned Huawei from US communications networks with a national security order. This act was implemented because the United States had concerns about the close ties between Huawei and the Chinese government, and they feared that Chinese authorities could acquire sensitive information on other countries and companies using Huawei equipment, especially considering the rise of the 5G technology (Kaska et al., 2019). This view was supported by Balding (2019), who highlighted the existence of a deep and lasting relationship between Huawei, its employees and the Chinese state. Finally, in June 2020 the US Federal Communication Commission classified Huawei and ZTE, both Chinese companies, as threats to national security. Advanced

¹ See the EU Regulation 2019/452 (<https://eur-lex.europa.eu/eli/reg/2019/452/>), the EC Working document on FDI in the EU (https://trade.ec.europa.eu/doclib/docs/2019/march/tradoc_157724.pdf) and a related data source called "The Foreign Ownership dataset—FOWN" (Gregori et al., 2019). It has been formally adopted on March 2019 by the European Parliament and the Council of the European Union, and became fully operational in October 2020.

² Press release of the European Commission (<https://trade.ec.europa.eu/doclib/press/index.cfm?id=2124>).

³ As of December 2019, only 15 out of 28 European Member States have FDI review mechanisms in place. These mechanisms mainly focus on M&As disregarding greenfield investments (while the new EU Regulation 2019/452 also covers Greenfields), differ in scope (e.g. review of intra- or extra-EU FDI, differing screening thresholds, breadth of sector coverage), process (e.g. pre-authorisation vs ex post screening of FDI), review timetables and enforcement, generating a non-homogenous review process among EU Member States. While the new regulation

technology assets are considered among the strongest assets of advanced economies, and the loss of their control in favour of foreign entities is seen as a strategic threat by many observers. For instance, the acquisition of the German industrial robot maker Kuka in 2016 by the Chinese home appliance maker Midea raised an intense debate about the need to protect national technologies, eventually leading to the introduction of stricter rules regarding the types of businesses that would need government approval to be sold to foreign entities.⁴

Worldwide M&A activity has intensified since the beginning of the century, especially in Europe, where inward M&A steadily increased in the second half of the 1990s, reaching for the first time comparable magnitudes with the United States in the 2000's, and maintained thereafter on high levels (e.g. Moschieri and Campa, 2014; Perafan-Peña et al., 2020). As shown in Figure 1, cross-border M&A flows increased in recent years, especially those targeting firms in high-technology industries, suggesting an increased appetite of foreign investors for certain business typologies.

[Figure 1 – Cross-border M&A flows in the EU]

In this context, political factors may affect the way in which foreign investments are perceived by authorities of the receiving countries, as well as the decision to invest by foreign investors. The common view in the political relations literature is that positive political linkages foster FDI, because on the one side political affinity decreases the probability of an expropriation of foreign assets by the host country's government (Nigh, 1985; Desbordes and Vicard, 2009; Desbordes, 2010) or its intervention against foreign firms' acquisitions (Duanmu, 2014; Bertrand et al., 2016). On the other side, foreign firms investing in countries characterised by good diplomatic relations with the country of their headquarters may benefit from more timely access to relevant information facilitated by public authorities and reduced political risks (Li et al., 2018). In fact, governments have an important role in bridging information and knowledge on foreign markets to local actors (Shimizu et al., 2004). Following this line of thought it is nevertheless also possible that conflicting political relations could undermine the exchange of knowledge and

⁴ As also discussed by Elisabeth Braw, "Cutting-edge tech takeovers are a strategic threat to the west", Financial Times, 2019 (<https://www.ft.com/content/763cae4e-e5ed-11e9-b8e0-026e07cbe5b4>).

information among countries, and market players may strategically acquire foreign companies to have direct access to valuable information and technological knowledge.

Our study advances the understanding of the relationship between diplomatic relations and foreign investment behaviours studying M&A flows in the EU in the period 2001-2019.⁵ The focus on the EU is primarily motivated by the lack of evidence about the relationship between diplomatic distance and FDI in Europe in spite of the steadily intensification of inward M&A in Europe since the second half of the 1990s (e.g. Moschieri and Campa, 2014; Perafan-Peña et al. 2020). Furthermore, previous studies on the role of interstate diplomatic relationship and FDI activity dealt with specific entry modes different than M&A, or did not specify the nature of entry. Bertrand et al. (2016) is the only study that addressed M&A, but using a low number of large foreign acquisitions involving listed acquiring and target companies. Moreover, policy interest about inward FDI recently grew in Europe due to the new FDI screening regulation introduced in 2020. Previous studies attributed an important role to public control in explaining the negative relationship between diplomatic distance and FDI activity that they empirically found in different contexts. Yet, it is not known to what extent European national authorities screened foreign acquisitions in recent decades on grounds of the affinity of foreign policy between the governments of investing and national countries rather than merely on the basis of economic reasons concerning markets fair competition and consumers' protection. This study fills these gaps with prime evidence on the role of foreign diplomacy on incoming foreign acquisitions and implications on the attitude of European national authorities towards them.

We implement an augmented gravity model with the volume of EU inbound M&A flows as the dependent variable and diplomatic distance as focal independent variable. To that purpose, we construct a measure of dyadic diplomatic relations between the country of the investor and the country of the target company using an index of country-pairs' votes alignment in the United Nations General Assembly (UNGA), as in Bailey et al. (2017). By contrast with dominant evidence found in the literature on political

⁵ While FDI includes M&A and greenfield investments, we focus on M&As, which are the main mode by which multinational firms engage in FDI (Blonigen and Pierce, 2016), especially among developed countries (see the World Investment Report released annually by the United Nations Conference on Trade and Development, last issue: https://unctad.org/system/files/official-document/wir2021_en.pdf), and more likely to be perceived as a threat by the host country. In fact, on the one hand, greenfield FDI are generally encouraged by receiving countries through specific policies, such as the implementation of a favourable legal regime or direct subsidies, because they are perceived, especially in R&D intensive industries, as an engine of innovation generating positive externalities and R&D investments (Bertrand et al., 2012). On the other hand, M&As are generally subject to scrutiny and restrictions, because host governments may have concerns in relation to the acquisitions of national firms by foreign investors (Gregori and Nardo, 2021). As a matter of fact, before the recent introduction of the new EU Regulation in October 2020, the majority of EU countries were not screening greenfield FDI on grounds of security and public order.

relations and FDI, we find a positive relationship between diplomatic distance and M&A activities, suggesting that cross-border acquisitions of European companies could be a way for the investing firm to mitigate weak diplomatic relations' related issues, such as access to host markets' information and technology. These findings are confirmed especially when foreign investors target technology-intensive firms, are private (rather than state- owned) enterprises and buy larger shares of the target companies.

The rest of the study is organised as follows. Section 2 discusses the related literature, while Section 3 presents the empirical methodology and the dataset. Section 4 shows the results and related discussion. In Section 5 we implement a series of robustness checks, and Section 6 concludes.

2. Conceptual framework

The effects of political and cultural factors on foreign investments have raised the attention of many authors. Most studies share the view that political and cultural proximity enhances trade and FDI flows. For instance, Busse and Hefeker (2007) study the effect of political risk and institutions on FDI flows for developing countries. The authors show that government stability, law and order, and democratic accountability are positively linked to FDI. Gassebner et al. (2020) find that political risk decreases M&A inflows, because instability in the government of the destination country could generate formal rules' changes, lowering FDI expected returns. Demir and Im (2020) find that cultural institutes have a positive effect on bilateral trade and investment flows.

The positive contribution of political and cultural similarities among countries to bilateral trade and FDI flows is in line with many studies that focus on political relations, where positive political linkages foster FDI. In particular, a first group of studies (Nigh, 1985; Desbordes and Vicard, 2009; Desbordes, 2010) find that higher diplomatic risks negatively affect FDI of US multinational enterprises in developing countries, requiring higher return on investments. Analogously, Bertrand et al. (2016) document that lower political affinity requires a larger initial acquisition premium. In addition, Li et al. (2018) show that favourable diplomatic relations increase cross-border investments of Chinese firms. This body of evidence is based on the ground of two main driving forces. First, a lower level of political affinity is linked to a higher probability that the host government could intervene against foreign firms' acquisitions or expropriate foreign assets after the investment. In fact, as supported by the legitimacy theory, economic agents and observers in the host country are more likely to perceive the control of local assets from companies based in countries with misaligned foreign policy as a threat for national economic and security

interests (Eden and Miller, 2004; Bertrand et al., 2016; Ellis et al., 2018; Hasija et al., 2019) as well as a challenge to national identity and pride (Shenkar et al., 2008; Riad and Vaara, 2011). Consequently, governments of host countries are more likely to interfere by putting in place regulatory barriers. Second, foreign firms investing in countries characterised by good diplomatic relations can better access and leverage intergovernmental diplomatic connections, benefitting from more timely access to relevant information facilitated by public authorities (Li et al., 2018). In relation to our analysis, the findings of previous studies suggest the ex-ante prediction that positive diplomatic relationships among pairs of countries is related to an increase in bilateral FDI flows.

While the majority of previous empirical studies points to a negative relationship between diplomatic distance and FDI activities, there are reasons to expect such a relationship to not necessarily hold in unexplored contexts such as acquisitions of European companies. In fact, the risk of expropriation of investors' assets by destination countries' governments is low in democracies (Jensen, 2008). In addition, the screening mechanisms of foreign acquisitions on political grounds is more likely to be operating for deals that attract strong attention by involved stakeholders and the public opinion such as the foreign acquisitions of large listed target companies studied by Bertrand et al. (2016) – in reason of the economic scale of the deal – and Chinese outward FDI studied by Duanmu (2014) and Li et al. (2018) – in reason of the growing scale of Chinese foreign activities combined with the contrasted diplomatic relationships between the Chinese government and some developed countries. By contrast, the majority of incoming foreign activities in European countries may more easily be screened on economic reasons concerning markets fair competition and consumers' protection rather than on political considerations. In fact, available evidence indicates that the 'government control's channel is particularly important in host countries with weak impartiality of institutions (Li et al., 2018), which we argue is unlikely to be the case of European countries.

Li et al. (2018) also stressed the role that governments have in bridging information and knowledge on foreign markets to local actors by connecting them with foreign ones. They documented that Chinese companies with stronger connection with national and local authorities benefit from preferential access to information and consequently invest more in foreign countries with friendly relationships with China. Another mechanism can nevertheless operate in relation to the role of the governments in brokering knowledge on foreign markets to local companies. In fact, the worsening of the diplomatic relationship may provoke disruptions to such an information flow (Shimizu et al. 2004), to which local companies may react by strengthening their presence abroad to get direct access to valuable knowledge. Consistently

with the internalisation theory, this process may provide a learning opportunity for the investor fostering a bird's-eye view, as opposed to a parochial view (Buckley and Casson, 1976; Stahl and Tung, 2015; Buckley and Casson, 2020).

In contexts where the role of origin countries' governments as brokers of knowledge is prevailing, the relationship between diplomatic distance and FDI activity may become positive. The issue therefore requires an empirical investigation, which is the goal of the empirical analysis, which we carry out as described in the next section.

3. Empirical methodology and Data

3.1. Empirical methodology

A standard tool implemented in the empirical literature to study trade determinants is the gravity model,⁶ which identifies the size between trading partners and their distance as basic determinants for bilateral trade. We follow the literature where the gravity equation is used to analyse FDI positions (see, among others, Hijzen et al., 2008; Head and Ries, 2008; De Sousa and Lochard, 2011; Gregori and Nardo, 2021), contributing by investigating the relationship between diplomatic distance and M&A flows. The baseline equation can be defined as follows:

$$M\&A_{ij,t} = \exp[\beta_0 + \beta_1 DD_{ij,t-1} + \beta_3 \ln(Distance_{ij,t-1}) + \beta_4 \ln(GDP_{i,t-1}) + \beta_5 \ln(GDP_{j,t-1}) + \gamma Controls_{ij,t-1} + \delta_t + \varphi_i + \omega_j + \varepsilon_{ij,t}] \quad (1)$$

where $M\&A_{ij,t}$ represents the flow of cross-border M&As from country i to country j at time t . $DD_{ij,t-1}$ is the diplomatic distance indicator constructed upon the affinity of countries' votes in the UNGA, as further detailed in the following subsection. The standard gravity variables are included, namely the *Distance* among country pairs, and the *GDP* of both the origin and destination countries (Economou, 2019). Blonigen and Piger (2014) and Eicher et al. (2012) suggest that control variables such as cultural distance and the presence of trade agreements are particularly relevant in determining dyadic flows. Thus,

⁶ See the seminal paper of Tinbergen (1962) and the theoretical foundations provided by Anderson and Van Wincoop (2003). Helpman et al. (2008) and Melitz and Ottaviano (2008) provide additional contribution to the theoretical micro-foundations, suggesting that heterogeneous firms models are compatible with the gravity approach. Theoretical background and micro-foundations of gravity equations are provided by Head and Mayer (2014).

the model is augmented including the vector ***Controls***, to consider further dyadic time-invariant characteristics, namely contiguity, equal to 1 when two countries share the same border, the use of a common language, the presence of a former colonial link, a common legal origin and being part of a common regional agreement, and time difference among countries. Di Giovanni (2005) finds that institutional factors and are important in affecting cross-border M&As, and our model also includes a time-variant government indicator, named “rule of law”, for both origin and destination countries (see the next subsection for further details). All explanatory variables are lagged by 1 year to reduce potential endogeneity issues. Additionally, we include year fixed effects, δ_t , to capture global shocks, and acquiror and target country fixed effects (φ_i and ω_j respectively), to address issues related to omitted variable bias. Finally, $\varepsilon_{ij,t}$ is the zero-mean error. To account for potential heteroscedasticity, standard errors are clustered by country-pair.

To include every bilateral relation in the model, we manually insert the value zero when a country-pair does not have M&A flows.⁷ As a consequence, the dependent variable has a high frequency of zeros, generating a bias in the gravity regressors obtained from log-linearised ordinary least squares, because taking logs clears the sample from null observations (Helpman et al., 2008). Therefore, we estimate the model using the Poisson Pseudo Maximum Likelihood (PPML) estimator (Santos Silva and Tenreyro, 2006; Head and Mayer, 2014). The PPML estimators provide an additional advantage, thanks to its robustness to heteroscedasticity in log-linear gravity equations, for instance in case of correlation between the scale of the residual and countries’ GDP (Nordås and Rouzet, 2017).

3.2. Data

To implement the model delineated in the previous subsection, we build a dataset using different sources. The dependent variable (M&A) is constructed for the period 2001–2019 exploiting the Bureau van Dijk Zephyr database, a Moody’s analytics product, which contains information about M&A deals between country pair (in thousand Euro).⁸ We consider cross-border deals where the target company is in the EU28

⁷ We create a full matrix of country pairs per year, with a dimension equal to the number of origin countries multiplied by the destination country, generating 72,072 observations. As shown in the descriptive statistics (see Tab. 1), we have positive M&A values in 7,984 cases, meaning that we filled up all the other bilateral relationships with zeros.

⁸ Zephyr has been widely used in the literature (Reiter, 2013; Cló et al., 2017; Del Bo et al., 2017, among others). It provides information on different kind of deals, such as M&A, portfolio investments and Joint Ventures. It has a

and the deal is defined as completed.⁹ We also include, for each deal, all the details needed to perform the analysis, specifically the year of the agreement, information about the target firm to detect the destination country and the primary sector in which it operates. To define the country of origin of the investment, we consider the global ultimate owner (GUO) of the investor. Considering the complex structure of multinational firms, using the GUO allows us to better identify the country in which the decision to implement a specific M&A is actually undertaken (Alviarez et al., 2017; Gregori et al., 2019). Information about the GUO derives from Orbis (a Bureau van Dijk product which employ the same firms' identifiers as in Zephyr).¹⁰

Our focal explanatory variable (DD) measures the distance of countries' foreign policy relying upon the affinity of countries' votes in the UNGA. Previous research in political science and international business made frequent use of votes in the UNGA to infer countries' preferences (e.g., Desbordes, 2010; Bertrand et al., 2016; Li et al., 2018). Votes in the UNGA show countries' opinions – comparable both across time and between countries – on various issues covering political, social and economic domains (Voeten, 2000). Moreover, they are not binding providing no (or less) scope for strategic voting behaviour and conversely more room for countries to express their honest opinion (Gartzke, 1998). We construct a variable measuring the diplomatic distance of countries following Bailey et al. (2017), which use UNGA votes to elicit countries' preferences over foreign policy defined as ideal points.¹¹ Compared with previous measures of state proximity based on UNGA votes (Gartzke, 1998; Signorino and Ritter 1999; Strezhnev and Voeten, 2013), the approach by Bailey et al. (2017) enhances comparability across time by taking into account information about the content of the UN's agenda. We then transform ideal points into a measure of dyadic diplomatic distance by taking the absolute value of the difference of the ideal points of each country pair in our sample. This measure assumes that similar votes in the UNGA and therefore similar ideal points imply a good relationship and that they act cooperatively because they share similar views and understanding on world issues (Gartzke, 1998).

worldwide coverage starting from 1997 and it is updated daily, gathering information from a wide range of sources (such as financial journals, reports, company press releases, and company websites).

⁹ Therefore we exclude announced, rumoured or uncompleted investments, in order to focus on those deals that have actually been implemented.

¹⁰ In case that the investor is not part of a group, the GUO is the investor itself and therefore we consider the country in which it is located the direct investor.

¹¹ We retrieve ideal points in the UNGA voting database (Voeten et al., 2009), which is regularly updated and freely available (<https://blogs.commonsgorgetown.edu/erikvoeten/data/>).

Table 2 provides descriptive evidence on the distribution of diplomatic distances in the estimation sample for the investing countries with the largest investments, to better understand differences in the alignment of their foreign policy with European destination countries. It shows that diplomatic distances between EU Member States are generally low with a median equal to 0.1 across all EU Member States pairs and years. Diplomatic distances strikingly increase with origin countries outside the EU (median 1.5), though with notable heterogeneity. They are relatively low for Australia, Japan and Ukraine (median between 0.2 and 0.3), slightly increase for Canada (0.5) and the United Kingdom (0.6) and become relatively large for Russia (1.0), China (1.7), and, perhaps surprisingly, the United States (1.7). The most misaligned foreign policy (not shown in the table) is observed for Cuba, Egypt, Iran, Sudan and Zimbabwe (median above 2.3). Table 2 makes also clear that most of M&A value is accounted by acquiring companies based in a limited number of countries. The United States is the origin country with the largest value accounting alone for about a quarter of all inflows in the EU, while about half (49%) M&A value is accounted by intra-EU foreign M&A investments.

[Table 1 – Diplomatic distances – About here]

The standard gravity variables, distance and GDP, are taken from the CEPII database.¹² The additional control variables, included in the augmented gravity model because as suggested by the literature they could influence cross border investments, are retrieved from two different sources. The CEPII database provides the following dyadic variables: contiguity, common language, colonial links, common legal origin, time difference and the membership to a common regional agreement. The indicator “rule of law” is taken from the World Government Indicators database of the World Bank¹³ and considers institutional factors, such as the degree of property rights protection, and the extent to which a country has an environment where the basis for economic and social interactions is formed by fair and predictable rules. This indicator, estimated yearly at country level, includes perceptions of the incidence of crime, the effectiveness and

¹² See http://www.cepii.fr/CEPII/en/bdd_modele/presentation.asp?id=8 (Mayer and Zignago, 2011; De Sousa et al., 2012). From 2016 onwards, GDP is taken from the World Bank database. The variable “distance” is calculated as distance between the biggest cities of each country pair. Inter-city distances are weighted by the share of the city in the overall country’s population (Mayer and Zignago, 2011; De Sousa et al., 2012).

¹³ See <http://info.worldbank.org/governance/WGI>.

predictability of the judiciary system, and the enforceability of contracts, and it ranges from approximately –2.5 to 2.5 (see Kaufmann et al., 2011). Table 2 reports the descriptive statistics.¹⁴

[Table 2 – Descriptive statistics – About here]

4. Results

4.1. Baseline analysis

Baseline results are reported in Table 3. We first estimate a gravity model, including the core gravity variables (i.e. country distance and GDP of the origin and destination countries), bilateral and country characteristics, and year fixed effects (specification 1). We then add our main control variable of interest, diplomatic distance (specification 2), target and acquiror fixed effects (specification 3 and 4 respectively). This latter estimation shows the baseline model as presented in the previous section, equation (1).

We start by discussing the results related to our main control variable. Interestingly, diplomatic distance is positively related with M&A flows, meaning that an increase in the dissimilarity of voting behaviour at the UNGA is correlated with a higher volume of M&As targeting EU companies. Our evidence is in contrast with the view found in the literature that good diplomatic relations foster foreign acquisitions. As supported by the legitimacy theory, economic agents and observers in the host country are more likely to perceive acquisitions from companies based in countries with sharply misaligned foreign policy as a threat for national economic and security interests (Eden and Miller, 2004; Bertrand et al., 2016; Ellis et al., 2018; Hasija et al., 2019) as well as a challenge to national identity and pride (Shenkar et al., 2008; Riad and Vaara, 2011). However, our findings suggest that some channels to whom previous studies attributed the positive relation between diplomatic proximity and FDI activity, namely the risk of expropriation of investors' assets and obstacles to FDI activities by destination countries' governments, do not operate in the context of foreign acquisitions of European target companies.

The positive relation between diplomatic distance and inward M&As is, by contrast, consistent with the idea that a worsening in foreign relations between countries with overall friendly diplomatic relationships reduces access to information to foreign markets lowering business opportunities (Shimizu et al., 2004). This view is consistent with the internalisation theory, which suggests that weak bilateral

¹⁴ The correlation table can be found in the Appendix (Table A.1).

relationships can provide a learning opportunity for the investor also fostering a bird's-eye view, as opposed to a parochial view (Buckley and Casson, 1976; Stahl and Tung, 2015; Buckley and Casson, 2020). It is also in line with the empirical evidence suggesting that government have a role in bridging information and knowledge on foreign markets to local actors by connecting them with foreign ones (Li et al., 2018). The worsening of the diplomatic relationship may provoke disruptions to such an information flow (Shimizu et al., 2004), to which local companies may react by strengthening their presence abroad to get direct access to valuable knowledge.

The other control variables are substantially coherent with our ex-ante expectations and evidence found in previous studies. In relation to the core gravity variables, the higher the distance is between origin and destination countries, the lower the M&A activity is. In the same vein, companies of countries with a higher GDP are engaged with more investment activities, in line with previous studies (among others, see Eicher et al., 2012, Blonigen and Piger, 2014, and Economou, 2019). Yet, the significance of the destination countries' GDP reduces once fixed year and country effects are introduced. Country-pair contiguity is not statistically significant in our baseline estimation, while the positive coefficient of former colonial relationships and common legal origins suggest that cultural similarities increases M&As. Not surprisingly, the time difference between countries is positively related with foreign investments, in line with the idea of regional specialization and vertical integration in the production process (Marjit, 2007). The variable related to regional trade agreements is significant, suggesting a positive impact of these agreement on M&A activities. Rule of law shows a positive coefficient, significant especially in relation to the country of the investor, suggesting that institutional factors, such as high property rights protection as well as fair and predictable rules, are an engine not only to attract cross-border investments, as suggested by Di Giovanni (2005) and Bénassy-Quéré et al. (2007), but also to foster investors' decisions.

[Table 3 – M&A and Diplomatic Distance, Baseline – About here]

4.2. High-technology sectors

Given the importance of timely access to information for innovative companies operating in technology-intensive industries, and the strategic relevance of technological development for governments, we expect that the relationship between diplomatic relations and foreign investments could vary across

sectors. To dig into this aspect, we exploit the Eurostat aggregation of manufacturing and services industry that classifies 2-digit level NACE Rev. 2 industries according to their technological intensity.¹⁵

We separately estimate our model according to target firms' industry class, as reported in Table 3. Specifications 1 and 2 split the sample of deals into low- and high-tech industries. The latter firms comprise high-tech manufacturing as well as knowledge-intensive services, while the former ones refer to low- and medium-low technology manufacturing and non-knowledge-intensive services. Interestingly, diplomatic distance is significant in high-tech industries, while the contrary is true for M&A activities in low-tech ones. The finding on high-tech firms reinforces the idea that foreign investors may consider acquisitions as a tool to overcome poor diplomatic relations and have direct access to prime information. Following this evidence, we further distinguish between knowledge-intensive services and high-tech manufacturing, as shown in specifications 3 and 4. Our findings suggest that high-tech manufacturing drives the main result, as compared to knowledge-intensive services.

[Table 4 – Sectors – About here]

4.3. Acquiror specificities: state-owned, democratic locales and willingness to control

Previous studies documented the specificities of the investing behaviour of state-owned enterprises (SoE) as compared to private companies, suggesting the pursuit of non-financial motives or political goals (Knill et al., 2012; Clò et al., 2017). Moreover, SoE are likely to be subject to stricter scrutiny by the host country when trying to buy a foreign company for a variety of reasons including the perceived threat to national security and unfair support by origin's countries (Duanmu, 2014). How these specificities reflect in the relationships between M&A activities and diplomatic relations is difficult to predict ex-ante. Thus, we study the role of SoE's investor, defined as investors with a public GUO.¹⁶ Table 5 presents the results, splitting cross-border M&As in two groups of investors, private companies, specification 1, and SoE, specification 2. Results suggest that baseline results applies to private companies, while diplomatic distance is not related with M&A's decisions made by SoE, reinforcing the view that it is the private sector that is willing to overcome potential limitation due to a higher diplomatic distance, such as access to foreign market information, with a direct presence in the market of interest.

¹⁵ See Eurostat indicators on high-tech industry and knowledge - intensive services are available here: https://ec.europa.eu/eurostat/cache/metadata/Annexes/htec_esms_an3.pdf.

¹⁶ To have control, the public entity should own at least 50.01% of the firm's shares. To define an entity as public, we rely on the classification made by Orbis, specifically when the investor's GUO type is labelled as "public authority, state, government".

We also investigate whether investments from countries with different level of democracy could have different behaviour. We divide the countries of investing firms into high-democracy or medium-low democracy countries. To disentangle these groups, we exploit the 2019 democracy index elaborated by The Economist.¹⁷ Specifications 3 and 4 show the results, suggesting that our findings are confirmed for high-democracy countries.

Finally, we investigate whether our baseline results are different between Portfolio investments and FDI, being the former investment where the acquired stake of the target firm is less than 10% and the latter greater than 10% (specifications 5 and 6). The rationale is that investor should be interested in long-lasting investment (i.e. FDI) to exploit information in destination markets, while portfolio investment may follow speculative goals. Our baseline results are confirmed for FDI, while the diplomatic distance's coefficient is not significant for portfolio investments. This finding is in line by Yoon et al. (2020), who show for emerging countries acquiring firms in the UK, that weaker bilateral political relations, which are linked to higher transaction and coordination costs, rises the probability of the investing firms to get full ownership of the target, in order to increase efficient learning through a greater internalised control.

[Table 5 – Investor specificities – About here]

4.4. Change over time

In this section we split the time frame into three sub-periods, namely 2001–2007, 2008–2013 and 2014–2019. This is done to exacerbate potential structural breaks, in line with general macroeconomic conditions and investment flows, as also visually illustrated by the M&A inflows to the EU shown in Figure 1. The first period refers to the pre-2008 crisis, with a favourable investment climate. The second period corresponds to the overall shrink in international investment activities that followed the 2007–2008 sub-prime crisis and the subsequent sovereign debt crisis. The last period focuses on the recovery, where foreign investments invigorated.

Table 6 shows the results, indicating that before the 2008 crisis diplomatic distance had a positive relation on M&A inflows to EU. This positive link disappears during the crisis years, and kicks in again in the recovery phase started in 2014. Therefore, these results suggest that the diplomatic distance-M&As

¹⁷ See <https://www.in.gr/wp-content/uploads/2020/01/Democracy-Index-2019.pdf>. High democracy countries are those identified as “full democracy”, while medium-low democracy countries are identified as “flawed democracy”, “hybrid regime” or “authoritarian regime”.

positive relation is confirmed during economic booms, and possible falls in asset values due to economic crises and related profitable opportunities for investors (Weitzel et al., 2014) does not seem to play a role in this context.

[Table 6 – Splitting the sample period – About here]

5. Robustness checks

In this section we implement a series of robustness to validate our findings, as discussed in the previous sections.

Table A2 shows the first series of robustness checks. Considering that the United States is a key EU foreign investor partner, it could be the main driver of the results. We re-estimate the baseline model excluding every deals with a GUO located in the United States, and results are confirmed (specification 1), thus excluding that our evidence is linked to a single country, namely the United States. We also test the extent to which main results are affected by the United Kingdom (specification 2), considering its specific history (such as the Commonwealth and the ongoing interlinkages among these countries) and its intrinsic nature as an independent EU country confirmed by Brexit, fully in place since January 2021. In specification 2 we exclude the United Kingdom and results are confirmed. Then, we test our results when China is excluded (specification 3), and results still hold also when excluding contemporaneously the United States, the United Kingdom and China (specification 4).

In specification 5, we include further fixed effects on our baseline estimation, as specified in equation (1). Specifically, the inclusion of year interacted with both acquiror and destination countries generate the drop of collinear control variables (i.e. GDP and Rule of law), but confirms the positive relation between diplomatic distance and M&A activities at the 1 per cent significance level.

In addition, we check the robustness on strategic location of the investor. It could be claimed that the analysis might be biased by strategic location of Global Ultimate Owners driven by fiscal reasons. For instance, a company could be located in a high-tax country and its GUO, strategically, in a tax haven to lower the overall tax burden. To address this point, we exploit the tax haven classification of Gravelle

(2013),¹⁸ as it is widely used in the literature (see, among others, Fatica and Gregori, 2020), excluding investors with the GUO from these countries. As shown in specification 6, the significance of the main coefficient of interest is confirmed.

Results are also confirmed for further robustness checks.¹⁹ We tested for diplomatic distance's non-linear relationship, adding as control the quadratic term. While the linear coefficient is still positive and significant, the quadratic one is not statistically different from zero. We also used alternative estimators, namely OLS and Gamma Pseudo Maximum likelihood estimator, as suggested by Head and Mayer (2014). Furthermore, we check that our findings are not affected by controls characterised by a high correlation. As shown in the correlation table (Table A1), there is a high correlation between "distance" and "time difference", and between "time difference" and "regional trade agreements". We test the baseline model excluding in turn: (i) both "time difference" and "regional trade agreements"; (ii) only "time difference"; (iii) only "regional trade agreements", and main results are confirmed.

6. Conclusions

This study investigates the link between diplomatic relations and M&A activities, implementing a gravity model. To proxy diplomatic relations, we exploit the dyadic countries' voting behaviour at the UNGA, creating an index of diplomatic distance.

In contrast with the dominant evidence found in the literature on political relations and FDI, we find a positive relationship between diplomatic distance and M&A activities in the EU. This finding suggests that some of the mechanisms to whom previous studies attributed the positive relationships between diplomatic proximity and FDI activity they found in different contexts do not operate in Europe. In particular, the risk of expropriation of foreign assets and obstacles to foreign acquisitions made by governments of receiving countries for political reasons appear to have played no or limited role in inward cross-border acquisitions of European target companies. By contrast, the finding is consistent with the idea that a worsening in foreign relations between countries with overall friendly diplomatic relationships reduces access to information to foreign markets to foreign markets by economic actors, which may find

¹⁸ Gravelle (2013)'s tax havens combines the following sources: (i) Hines and Rice (1994), more oriented to business issues; (ii) Tax Justice Network, "Identifying Tax Havens and Offshore Finance Centers: http://www.taxjustice.net/cms/upload/pdf/Identifying_Tax_Havens_Jul_07.pdf"; (iii) OECD (2000). See Gravelle (2013) for further details.

¹⁹ Tables available upon request from the authors.

more difficult to leverage intergovernmental diplomatic connections (Li et al., 2018). Therefore, from the point of view of the foreign investor, a deterioration of diplomatic relations limits their access to information about target firms, the industry in which those targets operate and the host country (Shimizu et al., 2004). Companies may react to the disruptions of information flow by strengthening their presence abroad to get direct access to valuable knowledge. This view is consistent with the internalisation theory, which suggests that weak bilateral relationships can provide a learning opportunity for the investor also fostering a bird's-eye view, as opposed to a parochial view (Buckley and Casson, 1976; Stahl and Tung, 2015; Buckley and Casson, 2020).

Furthermore, we distinguish foreign investments according to the technology-intensity of the target company's industry, finding that diplomatic distance exerts a significant impact especially for technology-intensive deals. This evidence reinforces the idea that foreign investors may consider acquisitions as a tool to overcome weak diplomatic relations and have direct access to prime information. In addition, results are confirmed for private (rather than state-owned) investors, as well as for long-lasting investments and not for speculative ones. Disentangling our time-span based on M&As' boom and bust, there is evidence that our findings are confirmed in periods characterised by a growing M&A activity.

While providing first evidence on the relationship between interstates diplomacy and cross-border M&As in Europe, this study has some limitations. In particular, the analysis is geographically restricted to EU28 destination countries. Moreover, the foreign entry mode covers cross-border M&As only. The extension of our framework to other countries (for instance the United States) or geographical blocs (for instance Asian emerging countries) as well as the comparison of the role of bilateral diplomatic relationship in M&A activity by entry mode can provide interesting novel insights and could be addressed in future research.

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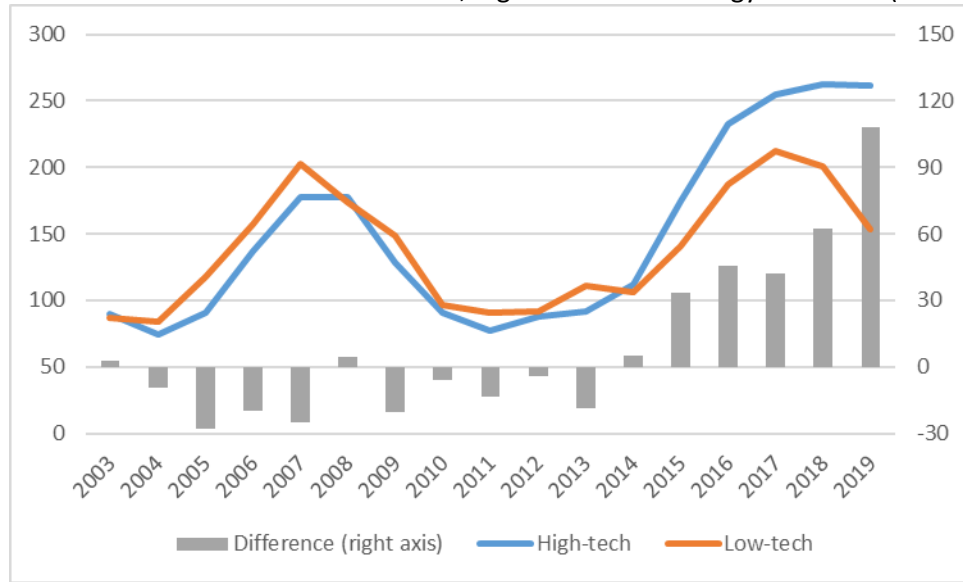
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Figure 1: Cross-border M&A flows in the EU, high- vs low-technology industries (billion Euro)



Notes: Authors' elaborations on Zephyr database. Data refer to cross-border M&As in the EU28 during the period 2001–2019 in billion Euro (three-year moving average). The blue line refers to M&As involving target firms in high-tech target industries, while the orange line to target firms in low-tech industries. The difference is reported in grey (right axis). Following the Eurostat definition, low-tech industries refers to low- and medium-low technology manufacturing and non-knowledge-intensive services. High-tech industries refers to medium-high- and high-technology manufacturing and knowledge intensive services.

Table 1. Diplomatic distances of the 20 largest investing countries with EU destination countries

Country of the acquirer	% of total M&A value	Diplomatic distance with destination countries				Cumulated % of total M&A value
		median	minimum	maximum	standard deviation	
United States	24.6	1.660	0.824	2.876	0.244	24.6
United Kingdom	10.1	0.625	0.037	2.040	0.188	34.7
France	8.2	0.453	0.037	1.799	0.176	42.9
Netherlands	7.0	0.102	0.000	1.412	0.166	49.9
Germany	5.6	0.124	0.001	1.378	0.171	55.5
Japan	4.2	0.332	0.002	1.071	0.205	59.7
Switzerland	3.1	0.236	0.000	1.102	0.209	62.8
Spain	2.9	0.089	0.001	1.165	0.167	65.7
Italy	2.9	0.101	0.000	1.238	0.163	68.7
Luxembourg	2.7	0.093	0.000	1.245	0.166	71.4
Canada	2.6	0.512	0.001	1.915	0.335	73.9
Ukraine	2.5	0.219	0.002	1.385	0.284	76.4
China	2.5	1.717	0.523	2.628	0.267	78.9
Sweden	1.9	0.158	0.000	1.239	0.185	80.9
Norway	1.6	0.118	0.000	1.213	0.168	82.5
Ireland	1.6	0.211	0.002	1.108	0.190	84.1
Australia	1.4	0.357	0.000	1.668	0.203	85.5
Russia	1.2	0.974	0.342	1.810	0.233	86.8
Belgium	1.1	0.091	0.000	1.449	0.168	87.9
Finland	1.1	0.109	0.001	1.209	0.166	89.0

Notes: Median, minimum, maximum and standard deviation statistics are computed on the distribution of diplomatic distance between each of the 20 largest investing countries and EU28 countries between 2001 and 2019.

Table 2. Main descriptive statistics

Variables	Source	Obs.	Mean	SD	Min.	Max.
<i>Dependent variable</i>						
M&A	Zephyr	7,984	664.17	2,908.16	0	115,586.61
<i>Main control variable</i>						
Diplomatic distance	Bailey et al. (2017)	7,984	0.65	0.68	0	3.36
<i>Bilateral indicators</i>						
Distance (in log)	CEPII	7,984	7.65	1.08	5.08	9.85
GDP of the origin country (in log)	CEPII, World Bank	7,984	27.01	1.79	18.63	30.65
GDP of the destination country (in log)	CEPII, World Bank	7,984	26.76	1.56	22.19	29.00
Contiguity	CEPII	7,984	0.12	0.33	0	1
Common language	CEPII	7,984	0.10	0.31	0	1
Colonial links	CEPII	7,984	0.09	0.28	0	1
Common legal origins	CEPII	7,984	0.31	0.46	0	1
Time difference	CEPII	7,984	2.58	3.11	0	12.00
Regional trade agreements	CEPII	7,984	0.67	0.47	0	1
Dummy for origin country from the EU28		7,984	0.53	0.50	0	1
<i>Government indicators</i>						
Rule of Law of the origin country	World Bank	7,984	1.13	0.84	-1.63	2.10
Rule of Law of the destination country	World Bank	7,984	1.24	0.62	-0.26	2.10

Notes: Data for M&A refer to the period 2001–2019 in million Euro (one observation for each country pair, year and subsector), while for all other variables data relate to the period 2000–2018 (they are lagged by 1 year to limit endogeneity issues). GDP values are in billion Euro. The table includes information for observations where the value of M&A is positive.

Table 3. M&As and diplomatic distance, baseline estimation

	(1)	(2)	(3)	(4)
Diplomatic Distance _{ij,t-1}		0.31** (0.13)	0.27** (0.12)	0.33** (0.15)
ln(Distance) _{ij,t-1}	-1.02*** (0.16)	-1.03*** (0.16)	-0.86*** (0.13)	-0.60*** (0.17)
ln(GDP - origin country) _{i,t-1}	0.80*** (0.04)	0.79*** (0.04)	0.79*** (0.04)	0.64** (0.28)
ln(GDP - destination country) _{j,t-1}	0.83*** (0.06)	0.82*** (0.06)	0.90* (0.48)	0.92* (0.50)
Contiguity _{ij,t-1}	-0.76*** (0.20)	-0.75*** (0.20)	-0.36* (0.21)	-0.06 (0.22)
Common language _{ij,t-1}	0.27 (0.23)	0.26 (0.23)	0.02 (0.22)	0.36* (0.21)
Colony _{ij,t-1}	0.61** (0.24)	0.59** (0.23)	0.47** (0.21)	0.37* (0.22)
Common legal origins _{ij,t-1}	0.27 (0.17)	0.33* (0.17)	0.31** (0.15)	0.22* (0.12)
Time difference _{ij,t-1}	0.17*** (0.05)	0.17*** (0.05)	0.14*** (0.05)	0.32*** (0.11)
Regional trade agreements _{ij,t-1}	0.08 (0.30)	0.24 (0.28)	0.19 (0.25)	2.19** (0.90)
Rule of Law - origin country _{i,t-1}	0.54*** (0.15)	0.64*** (0.17)	0.67*** (0.18)	1.25** (0.55)
Rule of Law - destination country _{j,t-1}	0.47*** (0.14)	0.47*** (0.13)	-0.64 (0.40)	-0.62 (0.40)
Year fixed effects	yes	yes	yes	yes
Target country fixed effects	no	no	yes	yes
Acquiror country fixed effects	no	no	no	yes
Observations	64,092	64,092	64,092	64,092
Number of acquiror countries	122	122	122	122
Number of target countries	28	28	28	28
Pseudo-R ²	0.653	0.655	0.678	0.731

Notes: This table shows the results from implementing the PPML model. The dependent variable is the value of bilateral M&A in thousand Euro and covers the years 2001–2019. All explanatory variables are lagged by 1 year and cover the period 2000–2018. Robust standard errors clustered by country pair are shown in parenthesis. The symbols *, ** and *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively.

Table 4. M&As in High-and Low-tech sectors

	(1)	(2)	(3)	(4)
			High-tech industries	
	Low-tech industries	High-tech industries	Knowledge-intensive services	High-tech manufacturing
Diplomatic Distance _{ij,t-1}	0.22 (0.29)	0.83** (0.36)	0.10 (0.24)	1.17* (0.61)
ln(Distance) _{ij,t-1}	-0.79*** (0.24)	-0.31 (0.27)	-0.57*** (0.21)	-1.53*** (0.54)
ln(GDP - origin country) _{i,t-1}	1.43*** (0.34)	-0.21 (0.63)	0.42 (0.36)	0.06 (0.84)
ln(GDP - destination country) _{j,t-1}	0.80 (1.11)	-0.05 (1.37)	1.00 (1.10)	7.08*** (2.35)
Contiguity _{ij,t-1}	-0.03 (0.25)	-0.31 (0.49)	-0.13 (0.35)	-1.79** (0.71)
Common language _{ij,t-1}	0.46 (0.30)	0.53 (0.61)	-0.21 (0.27)	2.16*** (0.71)
Colony _{ij,t-1}	0.37 (0.27)	-0.44 (0.44)	1.16*** (0.26)	-0.29 (0.50)
Common legal origins _{ij,t-1}	0.15 (0.13)	0.61* (0.33)	0.15 (0.17)	-0.11 (0.43)
Time difference _{ij,t-1}	0.11 (0.14)	0.65** (0.30)	-0.11 (0.14)	1.73*** (0.55)
Regional trade agreements _{ij,t-1}	1.02** (0.50)	-0.22 (0.91)	0.50 (0.63)	-2.60*** (1.00)
Rule of Law - origin country _{i,t-1}	0.02 (0.57)	6.08*** (2.23)	2.48*** (0.83)	7.61** (3.01)
Rule of Law - destination country _{j,t-1}	-1.51 (0.93)	-0.09 (1.32)	-0.46 (0.74)	-0.18 (2.42)
Year fixed effects	yes	yes	yes	yes
Target country fixed effects	yes	yes	yes	yes
Acquiror country fixed effects	yes	yes	yes	yes
Observations	55,636	43,568	53,508	30,344
Number of acquiror countries	106	83	102	58
Number of target countries	28	28	28	28
Pseudo-R ²	0.536	0.569	0.550	0.642

Notes: This table shows the results from implementing the PPML model. The dependent variable is the value of bilateral M&A in thousand Euro and covers the years 2001–2019. All explanatory variables are lagged by 1 year and cover the period 2000–2018. Following the Eurostat definition, Low-tech industries refers to *low- and medium-low technology manufacturing* and *non-knowledge-intensive services*. High-tech industries refers to *high-technology manufacturing* and *knowledge intensive services*. Robust standard errors clustered by country pair are shown in parenthesis. The symbols *, ** and *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively.

Table 5. M&As and investors specificities

	(1)	(2)	(3)	(4)	(5)	(6)
	Private	SoE	High democracy countries	Medium- low democracy countries	Portfolio	FDI
Diplomatic Distance _{ij,t-1}	0.33** (0.16)	-0.31 (0.96)	0.34** (0.16)	0.30 (0.68)	-0.39* (0.22)	0.66*** (0.22)
ln(Distance) _{ij,t-1}	-0.62*** (0.16)	-2.06*** (0.66)	-0.69*** (0.17)	3.33** (1.30)	-0.65** (0.29)	-0.57*** (0.19)
ln(GDP - origin country) _{i,t-1}	0.89*** (0.30)	1.80** (0.75)	0.84** (0.41)	1.33** (0.57)	1.26** (0.54)	0.51 (0.36)
ln(GDP - destination country) _{j,t-1}	0.67 (0.46)	2.04 (2.09)	0.72 (0.47)	5.66** (2.68)	0.68 (1.28)	0.83 (0.65)
Contiguity _{ij,t-1}	-0.16 (0.22)	-0.99 (0.81)	-0.18 (0.22)	1.84* (0.98)	-0.31 (0.32)	-0.17 (0.24)
Common language _{ij,t-1}	0.35* (0.21)	0.97 (0.59)	0.32 (0.21)	2.49** (1.05)	0.39 (0.33)	0.39 (0.28)
Colony _{ij,t-1}	0.35 (0.21)	1.31*** (0.44)	0.36* (0.21)	-0.50 (0.49)	0.37* (0.21)	0.46 (0.29)
Common legal origins _{ij,t-1}	0.29** (0.12)	0.08 (0.26)	0.32** (0.13)	-0.26 (0.25)	0.48*** (0.17)	0.25* (0.13)
Time difference _{ij,t-1}	0.28** (0.12)	1.10** (0.43)	0.30** (0.12)	-0.06 (0.40)	0.63*** (0.18)	0.13 (0.13)
Regional trade agreements _{ij,t-1}	0.36 (0.40)	2.75*** (1.07)	-0.18 (0.36)	4.71*** (0.70)	1.32** (0.60)	0.29 (0.36)
Rule of Law - origin country _{i,t-1}	1.87*** (0.53)	-1.37 (1.40)	1.86*** (0.55)	-0.04 (0.83)	-1.20 (0.74)	2.55*** (0.67)
Rule of Law - destination country _{j,t-1}	-0.83** (0.39)	-2.51 (2.12)	-0.70* (0.40)	-0.74 (1.10)	1.81** (0.85)	-1.13** (0.55)
Year fixed effects	yes	yes	yes	yes	yes	yes
Target country fixed effects	yes	yes	yes	yes	yes	yes
Acquiror country fixed effects	yes	yes	yes	yes	yes	yes
Observations	63,028	28,235	34,524	29,568	54,012	58,800
Number of acquiror countries	120	54	66	56	103	112
Number of target countries	28	28	28	28	28	28
Pseudo-R ²	0.743	0.475	0.717	0.744	0.671	0.606

Notes: This table shows the results from implementing the PPML model. The dependent variable is the value of bilateral M&A in thousand Euro and covers the years 2001–2019. All explanatory variables are lagged by 1 year and cover the period 2000–2018. SoE stands for State-owned Enterprises, while Private refers to non-SoE. Following the 2019 Democracy Index developed by The Economist, a country is identified as high-democracy if categorised as “Full democracy”, while it is medium-low democracy if it is “Flawed democracy, Hybrid/Authoritarian regime”. Portfolio includes M&As where the acquired stake is lower than 10%, while FDI considers M&As where the acquired stake is equal or greater than 10%. The symbols *, ** and *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively.

Table 6. M&As splitting the sample period

	(1)	(2)	(3)
	2001-2007	2008-2013	2014-2019
Diplomatic Distance _{ij,t-1}	0.61** (0.30)	-0.01 (0.19)	0.52** (0.24)
ln(Distance) _{ij,t-1}	-1.16*** (0.21)	-0.55** (0.22)	-0.18 (0.28)
ln(GDP - origin country) _{i,t-1}	1.26* (0.76)	1.90*** (0.51)	-1.14 (1.32)
ln(GDP - destination country) _{j,t-1}	0.50 (0.81)	-1.21 (1.39)	3.33* (1.87)
Contiguity _{ij,t-1}	-0.15 (0.27)	0.12 (0.21)	-0.14 (0.36)
Common language _{ij,t-1}	0.24 (0.27)	0.52** (0.22)	0.43 (0.32)
Colony _{ij,t-1}	0.50** (0.21)	-0.00 (0.21)	0.51 (0.33)
Common legal origins _{ij,t-1}	0.39*** (0.15)	0.34** (0.13)	0.05 (0.19)
Time difference _{ij,t-1}	0.18 (0.13)	0.21* (0.13)	0.38** (0.18)
Regional trade agreements _{ij,t-1}	0.29 (0.52)	-0.26 (0.47)	1.64*** (0.57)
Rule of Law - origin country _{i,t-1}	0.08 (0.60)	0.09 (0.95)	-0.34 (1.31)
Rule of Law - destination country _{j,t-1}	-1.45** (0.62)	1.43 (1.03)	0.28 (1.19)
Year fixed effects	yes	yes	yes
Target country fixed effects	yes	yes	yes
Acquiror country fixed effects	yes	yes	yes
Observations	17,472	16,464	17,304
Number of acquiror countries	91	99	104
Number of target countries	28	28	28
Pseudo-R ²	0.753	0.725	0.748

Notes: This table shows the results from implementing the PPML model. The dependent variable is the value of bilateral M&A in thousand Euro and covers the years 2001–2019. All explanatory variables are lagged by 1 year and cover the period 2000–2018. Robust standard errors clustered by country pair are shown in parenthesis. The symbols *, ** and *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively.

Appendix

Table A1. Correlation table

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
(1) M&A	1.00												
(2) Diplomatic distance	0.05	1.00											
(3) Distance	0.01	0.62	1.00										
(4) GDP of the origin country	0.16	0.11	0.19	1.00									
(5) GDP of the destination country	0.15	0.21	0.15	-0.06	1.00								
(6) Contiguity	0.01	-0.22	-0.49	-0.02	0.01	1.00							
(7) Common language	0.07	0.06	-0.07	-0.07	0.11	0.33	1.00						
(8) Colonial links	0.10	0.19	0.07	-0.09	0.09	0.12	0.47	1.00					
(9) Common legal origins	0.01	-0.04	-0.16	-0.09	0.01	0.27	0.29	0.28	1.00				
(10) Time difference	0.07	0.54	0.84	0.35	0.10	-0.26	0.01	0.08	-0.09	1.00			
(11) Regional trade agreements	-0.04	-0.62	-0.75	-0.25	-0.07	0.21	-0.03	-0.10	0.06	-0.83	1.00		
(12) Rule of Law of the origin country	0.07	-0.45	-0.28	0.13	-0.09	0.06	0.07	-0.04	-0.10	-0.20	0.35	1.00	
(13) Rule of Law of the destination country	0.10	0.13	0.07	0.01	0.39	0.01	0.17	0.10	-0.05	0.09	-0.06	0.01	1.00

Table A2. M&As and diplomatic distance, robustness checks

	(1)	(3)	(2)	(4)	(5)	(6)
	US excluded	UK excluded	CN excluded	US, CN and UK excluded	Country and Year interactions	No tax havens
Diplomatic Distance _{ij,t-1}	0.52** (0.22)	0.37** (0.17)	0.34** (0.16)	0.69*** (0.26)	0.43*** (0.16)	0.42** (0.17)
ln(Distance) _{ij,t-1}	-0.78*** (0.17)	-0.63*** (0.19)	-0.62*** (0.18)	-0.75*** (0.18)	-0.66*** (0.15)	-0.69*** (0.18)
ln(GDP - origin country) _{i,t-1}	0.71** (0.31)	0.62** (0.30)	0.49 (0.36)	0.50 (0.44)		0.61** (0.27)
ln(GDP - destination country) _{j,t-1}	1.01* (0.53)	1.06** (0.52)	0.91* (0.50)	1.11** (0.55)		0.76 (0.52)
Contiguity _{ij,t-1}	-0.22 (0.22)	-0.03 (0.23)	-0.07 (0.23)	-0.14 (0.23)	-0.05 (0.18)	-0.03 (0.24)
Common language _{ij,t-1}	0.47* (0.27)	0.36* (0.21)	0.35 (0.22)	0.46* (0.27)	0.35* (0.18)	0.32 (0.28)
Colony _{ij,t-1}	0.43 (0.38)	0.45** (0.23)	0.34 (0.22)	0.50 (0.36)	0.34** (0.16)	0.43* (0.25)
Common legal origins _{ij,t-1}	0.22* (0.12)	0.21* (0.12)	0.25* (0.13)	0.25** (0.12)	0.26** (0.10)	0.29** (0.14)
Time difference _{ij,t-1}	0.21 (0.15)	0.35*** (0.11)	0.32*** (0.11)	0.19 (0.18)	0.26*** (0.10)	0.34*** (0.12)
Regional trade agreements _{ij,t-1}	2.36*** (0.91)	2.19** (0.90)	2.18** (0.89)	2.40*** (0.92)	-1.39* (0.72)	2.79*** (0.91)
Rule of Law - origin country _{i,t-1}	1.34** (0.58)	1.38** (0.58)	1.24** (0.56)	1.43** (0.63)		1.65*** (0.55)
Rule of Law - destination country _{j,t-1}	-0.56 (0.44)	-0.72* (0.43)	-0.59 (0.40)	-0.58 (0.49)		-0.66 (0.43)
Year fixed effects	yes	yes	yes	yes	yes	yes
Target country fixed effects	yes	yes	yes	yes	yes	yes
Acquiror country fixed effects	yes	yes	yes	yes	yes	yes
Year*Target country fixed effects	no	no	no	no	yes	no
Year*Acquiror country fixed effects	no	no	no	no	yes	no
Observations	63,560	63,579	63,560	62,515	34,036	53,192
Number of acquiror countries	121	121	121	119	122	101
Number of target countries	28	28	28	28	28	28
Pseudo-R ²	0.672	0.721	0.732	0.649	0.799	0.742

Notes: This table shows robustness checks from implementing the PPML model. The dependent variable is the value of bilateral M&A in thousand Euro and covers the years 2001–2019. All explanatory variables are lagged by 1 year and cover the period 2000–2018. Robust standard errors clustered by country pair are shown in parenthesis. The symbols *, ** and *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively.

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