ETLA
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THE RESEARCH INSTITUTE OF THE FINNISH ECONOMY
Lönnrotinkatu 4 B 00120 Helsinki Finland Tel. 609 900 Telefax 601 753

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Julianna Borsos

FOREIGN COMPANIES IN ESTONIA - INDUSTRIAL ENVIRONMENT AND EXPERIENCES

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Tiivistelmä: Keskusteluaiheraportti on osa Etlatieto Oy:n koordinoimaa Viron teollinen tulevaisuus - tutkimusprojektia. Tämän rinnakkaistutkimuksen tavoitteena oli selvittää, millaisissa olosuhteissa suomalaiset ja muunmaalaiset yritykset toimivat Virossa. Pyrkimyksenä oli kuvata kyseisten yritysten toimintaympäristöä käytyjen haastattelujen ja muun mahdollisen aineiston avulla. Samalla oli saatava selkeä käsitys sekä ulkomaisten yritysten toimintatavoista Viron teollisessa ympäristössä että Viroon etabloitumiseen johtaneista syistä. Lisäksi haastattelujen anti heijastaa hyvin Viron teollisuuden nykytilaa.

Tutkimuksen tuloksista voidaan päätellä, että Virossa on selvästi edistytty poliittisen ja taloudellisen tasapainon saavuttamisessa, erityisesti naapurimaihin nähden. Venäjän kehitykseen liittyvän epävarmuuden vuoksi useat yritykset palvelevat Venäjän markkinoita Virosta käsin. Myös Latvian, Liettuan ja Puolan markkinoille tullaan usein Virosta käsin. Oma valuutta ja sen matala lähtötaso loivat suotuisan kilpailuaseman. Lisäksi investointi-ilmapiiri on suotuisa ulkomaisille yrityksille, koulutettua työvoimaa on hyvin saatavilla ja suhteelliset työvoimakustannukset ovat alhaiset. Tämä onkin houkutellut erityisesti työvoimaintensiivisiä, mutta myös teknologiaintensiivisiä yrityksiä. Työn ja sijoitetun pääoman tuottavuus ovat alkaneet kasvaa ja ne ylittävät merkittävästi valtiollisten yritysten vastaavat indikaattorit. Suomalaisten yritysten kiinnostuksen kasvua kannustaa maantieteellinen läheisyys sekä kieli- ja kulttuurikynnyksen mataluus. Etabloitumista hidastavat kuitenkin tietyt vaikeudet, kuten pankkitoiminnan ja lainsäädännön puutteet, raskas byrokratia sekä kasvava rikollisuus.

Avainsanat: Suorat sijoitukset, Itä-Eurooppa, Baltian maat, Viro

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Abstract: The present discussion paper has been achieved as part of a research project known as The Competitive Advantage of Estonia, which is coordinated by Etlatieto Ltd. The initial objective of the study was to describe and analyse the Estonian industrial environment in which foreign companies operate in order to identify the emerging problems and opportunities concerning foreign companies. This was carried out with the help of interviews and the use of other relevant material. In addition, the study was to pay attention to the motives of foreign investors entering into the particular business arrangement, and whether their objectives and expectations were met in practice. Thus, the study well reflects the current state of the Estonian industry as well as describes the adaptation process of foreign companies all along the ongoing transition process in Estonia.

The results clearly indicate that considerable development has taken place in Estonia in both the political and economic sphere, particularly in comparison to neighbouring countries. Hence, several companies use Estonia as a bridgehead to Russian markets due to Russia's fluid situation. Other markets are also targetted, such as Poland, Latvia and Lithuania. The reappearance of the Estonian national currency and its low starting point created a positive competitive position. Furthermore, the investment climate is considered as positive among foreign companies and the availability of a well-educated and relatively cheap labour force is another major positive factor. These factors have attracted several foreign companies that are in labour-intensive sectors as well as some companies operating in technology-intensive sectors. The profitability of and productivity in foreign companies are eventually increasing to a significant degree and, moreover, they operate more efficiently than Estonian state-owned companies. Finnish companies have particularly been attracted by the geographical proximity as well as by the cultural and linguistic similarities. Some obstacles remain, though, due to bureaucratic hurdles, loopholes in the legislation, a handicaped banking sector, as well as increasing criminality.

Key words: Foreign direct investments, Eastern Europe, the Baltic States, Estonia

Executive Summary

The study concentrates on foreign companies' operating environment in Estonia by describing and analysing the various factors affecting foreign companies' operations and competitiveness. The various interviews have clearly revealed the emerging problems and opportunities that these investors have found within the Estonian industrial environment, which is experiencing a serious, and definitive, structural change. The nature of the structural change and problems involved in it are also described, as they clearly have an impact on foreign companies' activities. The study has also paid attention to the motives of foreign investors entering the Estonian market, to their companies' pattern of involvement, as well as to their specific characteristics. Finally, external factors, such as the government's FDI policies and international politico-economic relationships, are briefly discussed.

On the Nature of the Estonian Industry

The current situation of the Estonian economy is characterized by a permanent decline, which started in 1990, when real GDP fell by 8% and 11% in 1991. The decrease accelerated due to increasingly acute difficulties in maintaining the system of trade and distribution within the Soviet Union. Following a sharp drop in the early months of 1992, when the country experienced an exacerbation of the slump with a decrease of 39% in industrial production and of 21% in agriculture, output seems to have stabilized in recent months. Agriculture is still rather important for the Estonian economy as it represents 18% of GDP. The contraction in economic activity was primarily due to disruptions in trade with the former Soviet republics, which reduced the supply of critical intermediate inputs on which the Estonian industry became heavily dependent as a result of 50 years of Soviet-based industrialization.

For decades, the pace and pattern of industrial development were determined by the central planning system's needs, lacking incentives for cost efficiency. Until the end of 1989, around 80-90% of industrial output was produced by companies which were subject to administrative controls from the capital of the Soviet Union. In addition to this high degree of integration into the Soviet economy, another characteristic of the Estonian economy stands out: the *unbalanced industrial structure,* which was characterized by large-scale production, dependent on inputs delivered from other large-scale enterprises, often over great distances from other parts of the Soviet Union and, in turn, supplying markets throughout the Soviet Union. This resulted in an industrial structure with a high degree of dependence on links with other Soviet republics for both supplies of inputs and markets for outputs. This inevitably led, soon after Estonia's declaration of sovereignty, to a situation where dislocation in one part of the system quickly translated into production problems elsewhere. In a supply-constrained economy, it is the shortage of inputs that acts as the constraint on production rather than insufficient demand. A quick replacement of Soviet sources of supply and the creation of alternative markets has been difficult; the *stock-flow problem*[1] has become a crucial issue. Hence, Estonia's transition period has entailed the following features:

- Companies which would otherwise (in a market-based system) not be viable continue to operate and losses are on the charge of various banks or the government.

[1]See pp. 29-30

- Specific linkages between companies or between companies and banks and public-administrative bodies are maintained although they should be broken off.

- Various bahavioural characteristics of enterprises will change only gradually in such areas as
  - inventory behaviour
  - employment
  - output flexibility
  - orientation of sales and sales efforts towards different markets
  - determinants of investments, scrapping of capital goods

On the Overall FDI Development

Estonia was a pioneer among the former Soviet republics in implementing reforms. Estonia's departure of the ruble zone with the introduction of its own currency, the kroon, was the highlight of 1992. The country moved early to liberalize prices and modernize its legal and institutional framework needed in both the privatization of state enterprises and in improving business conditions for both Estonian and foreign companies. The main contents of measures both undertaken and planned include:

- Seeking to achieve a more important position in world markets
- Attracting and promoting foreign investments
- Creating permanent relationships with and participating in the activities of international institutions
- Liberalization of international transactions
- Supporting small and medium sized enterprises and promoting exports in order to improve competitiveness

Multinational companies have clearly taken notice of Estonia's efforts to build a strong foundation for its developing economy; some $250 million in foreign capital have flown into the country, mainly in the form of direct investments. FDIs play an increasing role in the restructuring of economies in transition as they often provide access to new technology and markets. As this fact has been realized in the Baltic states, there is clear competition among these countries to attract international risk capital, know-how and management skills.

The number of companies with foreign capital has increased steadily since 1987, and at a more rapid pace since 1991. After the first quarter of 1993, there were *4012 foreign capital enterprises in Estonia* for a total capital of 6.8 billion EEK, out of which 2.2 billion EEK or 32% represented the share of total FDIs. The majority of FDIs come from OECD countries, whose dominance can be explained by their significant experience in FDI activities as well as by their more competent utilization of the market potential in Estonia. The main foreign direct investors (either total ownership or partial ownership) are: Finland with 2147 companies, CIS with 784 companies, Sweden 471 companies, Germany and the USA 147 and 127 companies, respectively. Furthermore, the amount of companies with Swedish, Chinese and Irish participation has recently increased. 75% of all FDIs have been allocated to Tallinn, Estonia's capital.

The undertaken interviews have revealed an evolutionary pattern of *deepening involvement* by and *increasing complexity* of foreign companies' operations all along their presence in Estonia. The different stages of Estonia's transition process are further reflected in these companies' willingness and ability to operate efficiently and with greater involvement . There were two determining interacting forces that influenced the operation form chosen by the respective companies: firstly, *prior Estonian experience* and, secondly, the *prevailing reforms*, especially in the legislative context, at the time companies entered Estonia. The first interacting force involves the existense of a considerable amount of *beneficial relationships*, both on the firm level and on the governmental level. These relationships form a dense network in which positive contacts strenthen foreign companies' bargaining power and overall position in the Estonian economy. Both parties have mutually enjoyed the benefits emerging from these deepening and more complex relationships: foreign investors have brought their expertise, hard currencies and, in many cases, undertaken training programmes, while the other party has tried to facilitate the flow of information and shared its knowledge of markets and customers.

The second interacting force is related to the *legislative framework*, which is constantly experiencing radical changes. Other fields of reform that have to be undertaken in the transition process also strongly affect foreign companies' operations both on the macroeconomic and microeconomic as well as on the institutional level. The dynamic transition process, and key reforms on the company level, have strongly affected foreign companies' operation forms and, thus, the level of FDI commitment. The various changes in the form of operation reflect the pattern of increasing complexity and deepening involvement.

On the Driving Forces

The attractiveness of Estonia seems surprising, as the size of its market area is small. The reason to this phenomenon lies in the fact that the country has had a head start in fostering a positive private business environment relative to the other republics of the former Soviet Union. Additionally, Estonia enjoys the winning combination of geographic desirability as a trade route between Eastern and Western Europe, skilled labour, low wage rates, as well as considerable investment concessions and incentives. Analysing available information on FDIs in Estonia and the motivations of the study's case companies, it turns out that the foreign investor's motivations are based on the relatively well developed overall "investment climate", compared to other countries of the former Soviet Union.

The undertaken FDIs in Estonia are generally motivated by a wide set of strategic and economic considerations. The production cost factor has been an important but not a dominant FDI determinant in Estonia. For Finnish and Swedish companies cost and proximity together play an important role: a nearby production site in a bordering country provides an easily accessible alternative to domestic production. Thus, *lower production costs* go together with *low delivery and communication costs*. Most foreign investors were primarily thinking in terms of overall Baltic markets where joint ventures or wholly owned companies are used as bridgeheads. Often, the springboard position of the Baltic states into Russian markets has also been an important reason when undertaking FDIs. As Russian politico-economic tensions are, however, considered as rather problematic, Western investors are mainly concentrating on the Baltic area and are looking forward to taking advantage of their Estonian experiences in Russia, when uncertainties have diminished to a meaningful degree. Thus, the possibility *to enter new markets* and secure a *permanent presence and a market share* in anticipation of the region's eventual economic take-off have been important motives. Estonia is already currently used as an export base from which to exploit Western Europe's markets, even though the focus is on the FDI recipient country's markets. Finally, foreign investors have also been attracted by the *cheap and relatively well educated* labour force.

The Industrial Environment

The good availability of skilled labour in the industrial fields covered in this study well satisfies foreign investors. Furthermore, the level of *technical* know-how and education is, according to the interviewed investors, surprisingly high. In fact, it is widely thought that the underlying potential for successful industrial transformation derives from the *technical competence of the labour force*. The relative sophistication of the Estonian economy in the Soviet context could provide the necessary flexibility to adjust to the requirements of international trade. Therefore, particular attention should be given to the maintenance and further development of formal education in the field. As the economic system is being transformed into a totally different one from the planned system, on-the-job training has become crucial.

Salaries paid by foreign companies to Estonian workers, on the average, correspond to those paid by Estonian private companies. The wage levels differ particularly in the case of executives and personnel with academic background, who earn, compared to the average wages in Estonian companies, better in foreign companies. In Western terms, the differences are naturally not as significant as in Estonian terms, and, furthermore, wages are still considerably low in Western terms for foreign investors. For instance, most Finnish and Swedish companies' expenditures on wages per worker (in the operational level) in Estonia represent only 1/10 of those in the home countries, on the average.

Estonia has an *undersized service sector*, which is typical of the former socialist countries. This holds good particularly in the banking and insurance sector, which employs only 0,5% of the labour force in Estonia. Contracting activity in large state enterprises and the growth of corporate and entrepreneurial activity will probably shift the composition of large employment away from industry and agriculture toward the service sector. Foreign investors have particularly paid attention to the gaps still existing in the financial sector, especially concerning financial services such as *payment mechanisms* (both internal and external) and the provision of *adequate credits* at reasonable interest rates. Presently, Estonian banks give only short-term loans at a high 30% - 40 % monthly interest. Long-term loans, in turn, are rather unfrequent and non-existent. Additionally, many of the *institutions* needed in carrying out the creation as well as the maintenance of a suitable financial sector are non-existent. They are necessary in the mobilization of savings, in encouraging rational investment and resource allocation decisions by making credits available on the basis of expected profitability and ability to repay. Furthermore, they provide a source of non-inflationary finance for the government's borrowing needs.

In the areas of transport and communications, foreign companies are now going through a more effective period, as they have been able to adapt themselves to the situation and have found sound solutions to these issues. Transport deficiencies, often caused by inadequate transport services (and not, for instance, by the condition of roads, which actually are suitable for the needs of the industry), have forced some companies to excessive levels of *vertical* *integration* through the development of non-competitive transport fleets, while communications deficiencies have contributed to inadequate flows of information.

Perhaps even more important than the constraints from lack of physical infrastructure is the problematic legal infrastructure, which is continuously being reshaped. The emergence of different kinds of legislative acts, such as laws and decrees, has led to situations, where it remains sometimes unclear what exactly is *the legal basis* for a particular decision, and *how* and *where* it could be appealed against. The problem of competing and contradictory pieces of legislation has frequently been aggravated by the political process, due to the influence of various interests. For instance, the new Estonian government is currently taking a new course concerning FDI policies, the content of which still remains unknown. Thus, there is room for improvement.

As a consequence of the nation's openness and smallness, foreign trade and the development of international economic relations, as well as financial flows, have a huge impact on the nation's economic development. The contraction of domestic supply and demand in the past two or three years has made the economy even more vulnerable and dependent on external factors. The path Estonia has chosen in its trade policies seems to be the right one also from foreign investors' point of view, who actually point out that this is the only solution in the light of current economic situation. The total collapse of the previous Soviet system first created a bizarre situation, where domestic rivalry was missing. Hence, this situation was somewhat *offset by the openness to international competition* and global strategies. Here, by letting foreign rivals operate in Estonia, local potential companies have had the opportunity to learn and adopt new entrepreneurial skills and operation modes related to both international and domestic company-to-company trade. New trade partners have been found and trade relationships are becoming more and more confident and sustainable.

In addition, Estonia's free trade policy has brought various other benefits: indigenous companies have access to *modern technology* embodied in imported inputs at duty-free world prices; import competition provides a *competitive discipline* on domestic companies that would otherwise be lacking because of the limited size of the domestic market and the concentration of production inherited from central planning; and most importantly, the new trade regime provides a set of *domestic prices which reflect world prices,* thereby facilitating efficient production and investment decisions. Finally, in order to sustain the already achieved objectives related to trade policy, Estonia will need to:

- Resist growing protectionist pressures from the agricultural and industrial sectors.
- Develop enhanced access to markets in the West, including accession to GATT and intensified cooperation with EFTA and the EC.
- Increase the volume of trade with the East where this is justified economically by geographic proximity, installed capacity, and internationally competitive prices.
- Expand regional cooperation with other newly independent states in the areas of trade and investment.
- Facilitate exports by improving the operating environment as a whole (e.g. infrastructure, and the like).
- Foster a competitive environment that favors export production, particularly in industry and agriculture.

As an increasing number of foreign firms are investing in Estonia, *synergies* are being developed as foreign and local industrial firms are becoming each other's suppliers. Such demand enables developing *specialized inputs*, such as trained labor, marketing and distribution channels, and the like. The step-by-step creation of new related industries in Estonia could lead to the emergence of new competitive industries. The sharing of activities can occur in manufacturing, technology development, distribution, marketing or service. The latter is of special concern in all East-European countries, as it is particularly the service component that has been lacking. The emerging related and supporting (supplier) industries provide opportunities for information flow and especially for technical interchange. Furthermore, foreign industrial companies are an important source of dynamism and change for the exploitation of Estonia's innovative potential.

As investments will mature and local as well as regional linkages will be fortified, these activities will generate additional positive spillovers, thus encouraging additional investment. Local value added should inevitably rise as established foreign companies upgrade their technology to keep up with world markets. Until now, the possibility for potential foreign investors to operate in Estonia has brought not only export and employment opportunities, but also the very much needed Western technology. Foreign direct investment has made crucial production and marketing knowledge available to Estonian companies through the substitution of foreign physical and human capital for absent local factors. As local labour learns from the presence of foreign practice knowledge and equipment, *knowledge tends to become diffused* through labour mobility and informal contacts among managers. Foreign investors' experiences show that the introduction of modern technology has not faced overwhelming problems - at least less than expected. In effect, problems that have arisen mainly concern the "soft" part of the technology transfer, not the "hard" part, e.g., new equipment and machinery or R&D related to these two factors. As pointed out earlier, the technical competences of the Estonian labour force are outstanding. Efforts have had to be made in introducing Western management techniques, especially in the following areas: optimizing means of production, production planning that would be responsive to demand changes and conditions, inventory and cost control techniques as well as means of quality assurance and control, and, finally functions related to financial management and marketing.

The participation of foreign investors in the privatization process has been comparatively extensive, mainly in the fields of large privatization and in the establishment of joint ventures. Some of the investors are seriously-minded long-term investors who are interested in new markets and lower production costs, while a few others are looking forward to obtaining cheap assets and even to eliminating competitors. Foreign investors involved in this study mentioned various problems occuring in the Estonian privatization process in general, which are listed in table 9, p.61. Other problems are related to the complexity of negotiations when foreign investors buy, either totally or partially, a state-owned company. The partners in privatization with foreign investment usually include both the foreign and domestic company, as well as the state agency or ministry in charge of privatization. Hence, various diversified and sometimes conflicting interests are involved in the negotiation process. The total cost of acquiring a company is high due to the complex process and the fact that the acquisition inevitably involves extra expenditures generating from the restructuring of the company.

There are fears of foreign investors driving out Estonian indigenous competitors. For instance, the foodstuffs industry is already dominated by foreign companies. In the case of a transition economy, however, inward foreign direct investment is likely to *stimulate competition*, encourage a market structure conducive to the promotion of dynamic comparative advantage, and in the longer term, it should stimulate innovatory capacity.

The lack of competition in the past not only resulted in poor quality products, but also removed any incentive to be efficient in the use of inputs, such as labour, capital, raw materials or energy. Excessive costs through inefficient production were, instead, passed directly to the consumer or were covered by price subsidies. Introducing competition with the aid of foreign direct investments and by breaking up larger companies into smaller competing units, by encouraging the start-up of new companies, and by importing goods, is an important element in the transition process. It seems that the ownership advantages of foreign companies have the greatest impact on local competitors, as both the intangible and tangible assets are clearly lacking among local competitors. In addition, the more foreign companies possess such advantages which can be effectively transferred or developed in Estonia, the greater the potential impact on competitors. The form of entry also has an impact, when a significant acquisition is undertaken in a fast growing sector. For instance, the acquisition of the leading Estonian foodstuffs company by a Finnish multinational led to a situation where smaller competitors are hardly able to continue their activities.

On the External Factors

The most important tasks in the short term are the *effective implementation* of FDI policies, ensuring their *coherence, predictability* and *institutional coordination.* Foreign investors suggest that Estonia should *promote the efficient behaviour of both foreign and domestically owned economic units simultaneously.* This type of policy would favour a competitive domestic industry better than policies which particularly encourage foreign activities. FDI can act as a powerful catalyst for economic change, as its contribution goes beyond the entrepreneurial and financial engagements of the foreign investor. Yet, even though thousands of foreign companies have invested in Estonia and the number of projects with foreign participation is expanding rapidly, the overall volume of FDIs nonetheless *falls dramatically short of the external capital required for a rapid increase in the standard of living.* In order to attract additional investors in the growth-starved Estonia, policy-makers must be able to muster a *high degree of credibility* and there must be a preparedness to support clear, simple and market-oriented policies in the future. Until now, the country has shown a strong political commitment to democracy and the market-oriented economic system. Politico-economic relationships are working on a very good basis with Nordic countries and Western Europe, as a whole. Estonia is counting on its supporters in the West while dealing with problems related to its Russian minority.

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List of Abbreviations

BOE	Bank of Estonia
CEEC	Central Eastern European Countries
CIS	Commonwealth of Independent States
CMEA	Council for Mutual Economic Assistance
CPE	Centrally Planned Economy
CSCE	Conference on Security and Cooperation in Europe
EBRD	European Bank for Reconstruction and Development
EC	European Community
FDI	Foreign Direct Investment
FSU	Former Soviet Union
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
IMF	International Monetary Fund
MNC	Multinational Company
NATO	North Atlantic Treaty Organization
OECD	Organization for Economic Cooperation and Development
PHARE	Pologne Hongrie Action pour la Reconversion Economique
R&D	Research and Development
SOC	State Owned Company (or State Owned Enterprise, SOE)
UN	United Nations
WB	World Bank
WEU	Western European Union

1. Introduction

1.1 Background

Estonia is the new powerhouse of the Baltics, though it is the smallest country in the region with its territory of 45,215 square kilometers and its population of 1,6 million people. Currently, Estonia is clearly outstripping the other developing economies of the former Soviet republics. Estonia has implemented unusually liberal economic policies, including a free trade regime, and a remarkably stable domestic currency that is freely convertible at a fixed exchange rate for all current and most capital account transactions. Inflation has been reduced from 80% per month in early 1992 to an average of about 2% per month through the first half of 1993.

Estonia restored its independence on August 21, 1991 after half a century of Soviet occupation, during which the country's economy was closely integrated to the economy of the Soviet Union. The shortcomings of a centrally planned economy (CPE) became increasingly apparent during the 1980s. As a result, the movement toward economic and political independence gained significant momentum. Estonia declared its sovereignty in November 1988, and a law granting Estonia economic autonomy was approved by the Soviet Supreme Court the following year. Finally, after Estonia's declaration of independence, the country's sovereignty was recognized internationally. Since then, the nation has been facing the major task to create a politically independent and stable state as well as to transform its ecomy into a market based economy.

Estonia's efforts have widely been noticed internationally; the country is now enjoying the support of several multilateral institutions, such as that of the International Monetary Fund (IMF), which has further contributed to the rapid transition process. Foreign companies have shown huge interest, which can be seen in the form of their mounting investments. These investments are of vital importance to the country as they additionally bring not only capital but also knowledge of modern business behaviour and techniques. Thus, foreign investments are considered as a major vehicle in the transformation into a market economy.

Foreign companies have recognized Estonia's value as a hub for trade and transit, many of them have undertaken business operations with long-run perspectives: their aim is to position themselves in the Estonian market in order to take advantage of the country's unique characteristics, which will also be dealt in this study. Several companies have already acquired interesting and valuable experiences while operating in Estonia. These companies' experiences have mostly remained unknown despite the fact that their actions and presence have affected the Estonian economy to a great degree right from the first days of independence. As a great number of the various surveys and researches on the Estonian economy have not succeeded in covering the company related industrial environment and possible problems, an attempt was made to fill this gap mainly by interviewing a large pool of key people in foreign companies operating in Estonia. The results of this challenging task are presented in this discussion paper.

1.2 Objectives of the study

This study primarily aims at describing and analysing the different factors affecting foreign companies' operations and competitiveness in Estonia in order to identify the emerging difficulties and opportunities in their industrial environment. This has been carried out during the autumn 1993 by interviewing key people in 22 foreign companies, most of which are multinational companies (MNCs). The study also pays attention to the motives of foreign investors entering into the particular business arrangement, and whether their objectives and expectations have been met in practice. Furthermore, the study well describes the adaptation process of foreign companies all along the ongoing transition in the Baltic states.

The 30 interviews cover the following industrial fields: clothing and textile industry, foodstuff industry, electronics industry, oil and gas industry, construction industry, engineering industry, woodworking industry as well as two trading houses. Additionally, 5 experts well acquainted with the economy of the Baltic states have been interviewed. An extensive use of supplementary articles as well as of statistical data concerning these companies and their industrial environment was made. The situation of the key determinants in these companies' industrial environment is discussed and analysed by using the concept of competitive advantage, first introduced by Ansoff[1] , and recently by Porter[2]. Here, Michael E. Porter's concept is used only as a tool or as a frame for the study, due to the fact that it was merely created for modern companies and nations, whereas Estonia cannot yet offer a fully developed, modern environment. However, it is suitable in identifying the industrial environment both on the microeconomic and macroeconomic level as foreign companies' needs and expectations are closely tied to those of a modern, market-oriented economy. In order to find out on which criteria foreign companies' decision to actually locate their activities in Estonia are based on,

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[1]See Ansoff 1968

[2]See Porter 1980, 1985 and 1990

the specific characteristics of such companies are shortly discussed, based upon Dunning's[3] concept on international production.

1.3 Key features of the theoretical concepts

The purpose of this study is to discuss and analyse the underlying factors affecting foreign companies' activities in Estonia by examining the different elements of the Estonian industrial environment. Porter 's classification of these fundamental forces, which further underly national competitive advantage, forms the framework for analysis in this study.

The diamond model was created in order to answer one basic question: why a nation becomes the home base for successful international competitors in an industry? The issue lies in creating and sustaining national competitiveness as a function of certain industry characteristics. In order to understand the process which takes place in the creation of competitive advantage, one must take into consideration the interaction between specific industrial elements in the industrial environment and the operations of individual firms. There are four broad attributes in a nation that shape the industrial environment and determine the level of competitiveness depending on their *quality*, *quantity* and *interaction*. These attributes are:

1. *Factor conditions*: the amount, type, quality and composition of either natural or created factors of production, such as skilled labour or infrastructure, which are necessary to compete in a given industry.

2. *Demand conditions*: the level, type and growth of home demand for the industry's product or service.

3. *Related or supporting industries*: the presence or absence in the nation of supplier industries and related industries that are internationally competitive.

4. *Firm strategy, structure and rivalry*: The conditions in the nation governing how companies are created, organized, and managed, and the nature of domestic rivalry.

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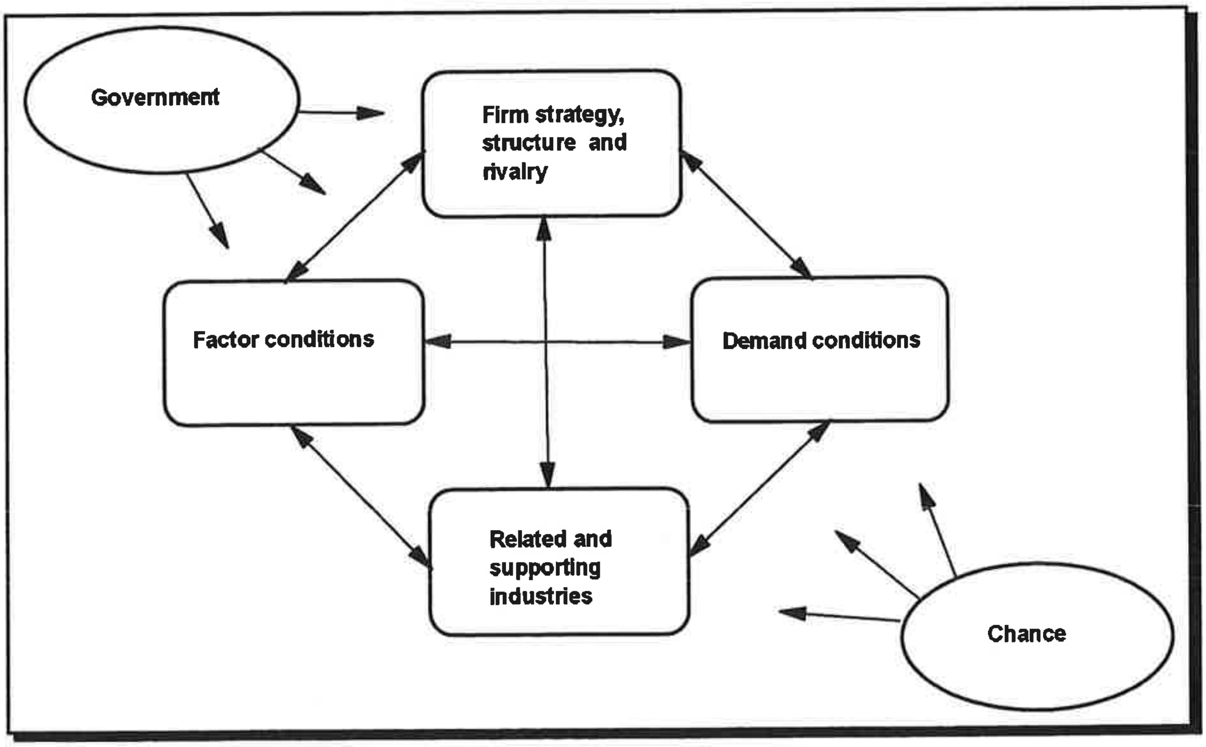
[3]See Dunning 1980, 1988a and 1988b

The way these attributes evolve over time and interact is as significant as the quantity and quality of each of them. Thus, the diamond model forms a *dynamic* system. Two additional variables can influence the industrial environment, namely, the *government* and *chance events*. The latter are developments outside the control of companies as well as of the government, such as external political developments, wars, inventions, breakthroughs in basic technologies, and major shifts in foreign market demand. Discontinuities that may reshape or unfreeze industry structure are created by these chance events, thereby providing the opportunity for one country's companies to supplant another's. Consequently, these chance events have traditionally played a key role in shifting competitive advantage in various industries.

The government is, to a great extent, able to improve or detract from the national advantage. Policies implemented without taking into consideration how they influence the entire industrial environment or the system of determinants are as likely to undermine the country's advantage as enhance it. Figure 1 sets the different determinants of national advantage, i.e., the diamond model:

Figure 1: The Determinants of National Advantage



The basic idea is that industries are connected through horizontal and vertical relationships; as a result, these industries are not isolated, on the contrary, they form so called *clusters of industries*. These various clusters reflect the state of the economy's development in a given country. This is why this model works as a framework in examining the industrial environment of foreign companies operating in Estonia: their experiences and views concerning the different factors of the model well reflect the development state of the Estonian economy.

One of the additional objectives of the study was to identify the motives of foreign investors entering the Estonian market and, if possible, to find out the industry-specific determinants. These factors as well as the special characteristics of foreign companies operating in Estonia are shortly discussed in the study with the aid of Dunning's eclectic paradigm. His model can be used to explain all types of foreign direct investment (FDI), which usually does not only include *capital transfer*, but also *the transfer of technology, know-how, managerial and marketing skills*[4].

The principal hypothesis of the eclectic paradigm is that a company will engage in foreign operations, in this case in FDI, if three conditions are satisfied:[5]

1. It possesses net *ownership advantages* vis-à-vis firms of other nationalities in serving particular markets. These ownership advantages largely take the form of the possession of intangible assets, which are, at least for a period of time, exclusive or specific to the firm possessing them.

2. Assuming condition 1 is satisfied, it must be more beneficial to the company possessing these advantages to use them itself rather than to sell or lease them to foreign firms, that is, for it to *internalise its advantages* through an extension of its own activities rather than externalise them through licensing.

3. Assuming conditions 1 and 2 are satisfied, it must be profitable for the company to utilise these advantages in conjunction with at least some factor inputs *located outside its home country*; otherwise foreign markets would be served entirely by exports and domestic markets by domestic production.

The greater the ownership advantages of the company, net of any disadvantages of operating in a foreign environment, the more the incentive it has to to exploit these. The more its production and marketing favour a foreign location, the more it is likely to undertake FDI. The presence of internalisation advantages suggests that companies will exploit these advantages by

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[4]Swedenborg 1979

[5]Based on Dunning 1981, 79

exporting or FDI rather than by contractual resource exchanges; whereas the equity investment alternative, rather than exports, will be chosen where locational advantages favour a foreign rather than a domestic production base. Table 1 summarizes the conditions underlying these choices.

Table 1: Alternative routes of servicing markets

Route of servicing market	Ownership	Internalization	Location
FDI	Yes	Yes	Yes
Trade in goods and services	Yes	Yes	No
Contractual resource transfers	Yes	No	No

One must note that particular types of FDI cannot be explained by the same ownership, locational and internalization advantages. Furthermore, these advantages interact with each other and are dynamic: they may change over time.

1.4 Limitations and design of the study

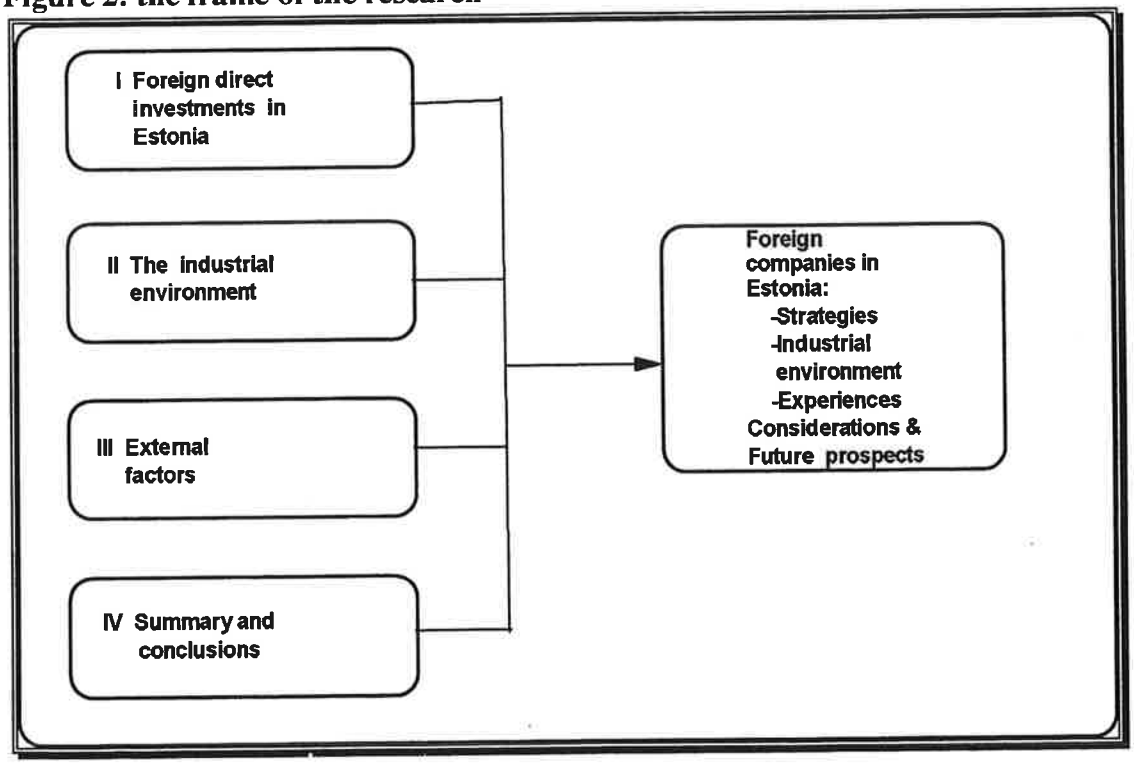
The present study focuses on Estonia's ongoing transition period, which started in 1989, and is limited to the current year, 1993. Some comments will be presented concerning future prospects, according to the results of the study. The companies involved in the study are internationally involved entities, which own / control production or service facilities outside their own country in which they are based. *Foreign direct investment* (FDI) is used to designate foreign companies' operations in Estonia; in these activities risk capital from one country is directly invested in another. Usually, FDIs are made to create or expand a permanent interest in a foreign company. They take the following forms: the foreign investor may enact an *acquisition*, either totally or partially, set up a *joint venture* with a local partner or establish a new, *wholly owned* company in the host country.

The present study starts with an overlook on foreign investments in Estonia, including recent economic developments, foreign companies' motives and expectations as well as their specific characteristics, Western involvement in the promotion of FDIs in Estonia and the particular sectors attracting foreign investors. All this is based on interviews and on other material.

The third chapter of the study focuses on foreign companies' industrial environment in Estonia and it seeks to describe key factors influencing their activities in various fields, which are: the factor conditions, demand conditions, related and supporting industries as well as firm strategy, structure and rivalry. This chapter is totally based on interviews as the very center of gravity in this study is on foreign companies' experiences.

Factors that are external to foreign companies and that are not, in most of the cases, in their control, will be briefly discussed and analysed in the fourth chapter. This includes examining the role of the government, relationships with neighbouring countries as well as economic relations with the European Union. Finally, conclusions are drawn in the fifth chapter and, simultaneously, future prospects are shortly discussed. Figure 2 represents the frame of the study.

Figure 2: the frame of the research



2. Foreign Direct Investments in Estonia

2.1 Economic reform: internationalization

Estonia was a pioneer among the former Soviet Republics in implementing reforms; the country has achieved significant progress in reforming its economic system. Estonia's departure of the Ruble zone with the introduction of its own currency, the Kroon, was the highlight of 1992[1]. The introduction of a freely convertible currency has shown to be a successful change in the Estonian economy as the Russian Ruble has continously been savaged by inflation nearing 100 percent a month . The Kroon has been remarkably stable during the first year vis-à-vis Western currencies. Estonia moved early to liberalize prices and modernize the country's legal and institutional framework needed both in the privatization of state enterprises and in improving business conditions for Estonian as well as for foreign companies.

The current situation of the Estonian economy is characterized by a permanent decline, which started in 1990, when real GDP fell by 8% and 11% in 1991. The decrease accelerated due to increasingly acute difficulties in maintaining the system of trade and distribution within the Soviet Union. Following a sharp drop in the early months of 1992, when the country experienced an exacerbation of the slump with a decrease of 39% in industrial production and of 21% in agriculture, output seems to have stabilized in recent months. Agriculture is still rather important for the Estonian economy as it represents 18% of GDP, the respective shares in 1992 were as follows:[2]

Table 2: Gross Domestic Product by sector

Industry	30%
Agriculture	18%
Services	17%
Trade	16%
Construction	9%
Transport and communication	7%
Energy	2%
Forestry	1%

[1]The Kroon was fixed to the D-mark at an exchange rate of DEM 1= EEK 8, the limit of fluctuation being -3% ... +3%.The Kroon is backed by gold and convertible currency reserves of the Bank of Estonia. In May 1993, the value of the reserves was EEK 3.3 billion (about $250 million at the time).

[2]Source: Estonian State Department of Statistics

The contraction in economic activity was primarily due to disruptions in trade with the former Soviet Republics, which reduced the supply of critical intermediate inputs such as chemicals, metal products and cotton, on which the Estonian industry became heavily dependent as a result of 50 years of Soviet based industrialization.

The launching of the new currency was accompanied by a strict stabilization programme, the main elements of which were:[3]

- Completion of the price reform process
- Restrictive fiscal policies aimed at balancing general government accounts
- Strict adherence to the provisions of laws and decrees related to the currency reform
- An income policy aimed at containing excessive wage increases in order to avoid an inflationary spiral
- Further liberalization of the exchange and trade system
- A comprehensive structural adjustment effort comprising privatization, financial sector reform, fiscal reform, improvement in the operation of the social safety net, and restructuring or closure of nonviable enterprises and banks.

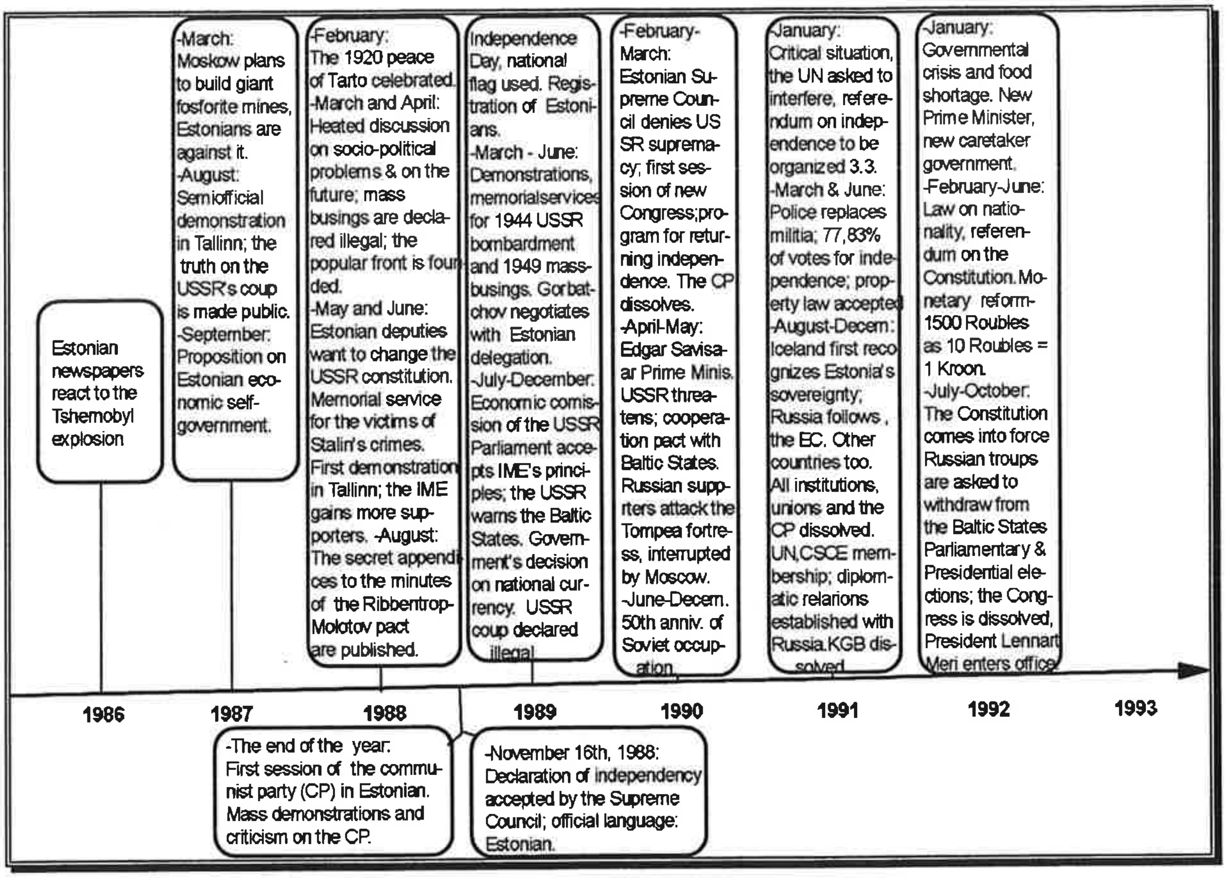
Details on the various reforms and their influence on foreign companies' economic activities in Estonia will be further discussed in the following chapters. Figure 3 sets the most important political and economic events that have taken place during the years 1986 - 1993.

It can be concluded that improving business conditions for both Estonian and foreign companies seems to form an important part of economic reform in Estonia. The main contents of measures both undertaken and planned shortly include:

- Seeking to achieve a more important position in world markets
- Attracting and promoting foreign investment
- Creating permanent relationships with and participating in the activities of international institutions in order to reduce economic discrimination
- Liberalization of international transactions
- Supporting small and medium sized enterprises and promoting exports in order to improve competitiveness

[3]Estonian ministry of Foreign Affairs 1993

Figure 3: Political and economic events in Estonia in 1986-1993[4]



2.2 The overall development of foreign direct investments

Multinational companies have clearly taken notice of Estonia's efforts to build a strong foundation for its developing economy; some $250 million in foreign capital have flown into the country, mainly in the form of direct investments. FDIs play an increasing role in the restructuring of economies in transition as they often provide access to new technology and markets. Actually, As this fact has been realized in the Baltic states, there is clear competition among these countries to attract international risk capital, know-how and management skills.

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[4] IME stands for a group that first advanced the opinion that Estonia should be granted economic autonomy; the proposition was first made on September 29, 1987. CP stands for communist party.

Foreign investment flows to Estonia were permitted again already during the country's last socialist years, as early as in January 1987, when the Decree on the Establishment and Operation of Joint Ventures in the Territory of the USSR with the Participation of Soviet Organizations and Firms from Capitalist and Developing Countries took effect. In September 1991, the Estonian *Law on Foreign Investments* came into force, thus forming the main pillar of the framework for foreign investments together with the Law on Tax Concessions for Foreign Capital Enterprises. According to the Law on Foreign Investments:

- Foreign investors and Estonian citizens or juridical persons have *equal rights.*
- Foreign investors' property *cannot be* nationalized, confiscated or expropriated.
- Foreign investments are *guaranteed* by the Republic of Estonia.

Furthermore, there are no restrictions concerning the various spheres of activities; however, licences are required in the following sectors:

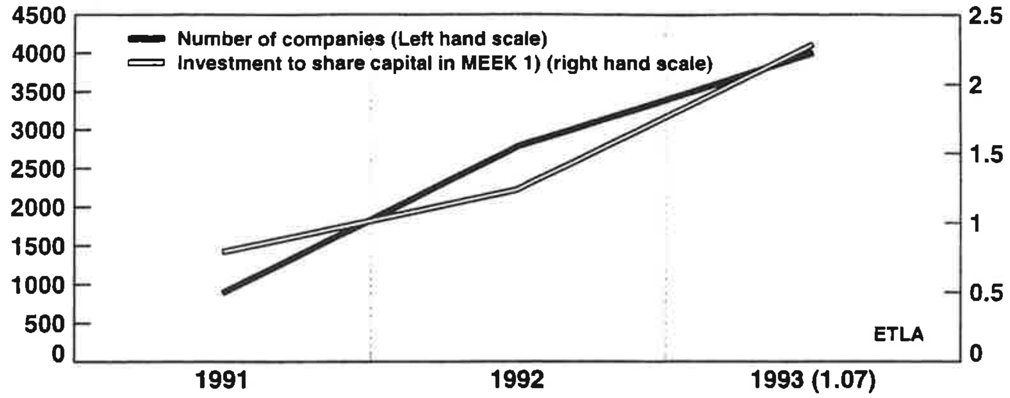
- Air transport and railway;
- waterways, ports, and other hydraulic structures;
- energetics, gas- and water supply;
- commercial banking;
- mining ; and
- telecommunications as well as communication networks.

Those companies that are subsidiaries and/or affiliated branches of foreign capital enterprises, are considered as foreign capital companies.

The number of foreign capital companies has increased steadily since 1987, and at a more rapid pace since 1991, as figure 4 indicates. After the first quarter of 1993, there were *4012 foreign capital enterprises in Estonia* for a total capital of 6.8 billion EEK, out of which 2.2 billion EEK or 32% represented the share of total FDIs[5]. The majority of FDIs come from OECD countries, whose dominance can be explained by their significant experience in FDI activities as well as by their more competent utilization of the market potential in Estonia. The main foreign direct investors (either total ownership or partial ownership) are: Finland with 2147 companies, CIS with 784 companies, Sweden 471 companies, Germany and the USA 147 and 127 companies, respectively. Furthermore, the amount of companies with Swedish, Chinese and Irish participation has recently increased.[6] Figure 5 sets the distribution (%) of the biggest source countries and the allocation of FDIs by economic sector (%):

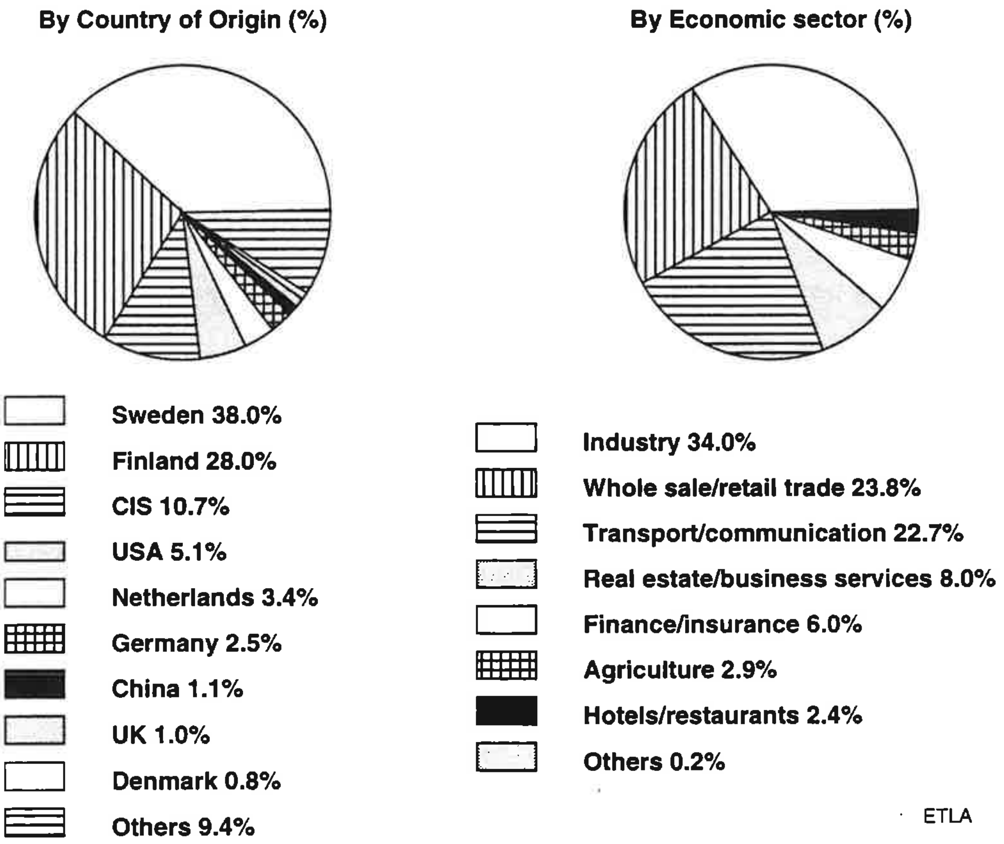
[5]Ministry of Finance of the Estonian Republic
[6]Venesaar & Vitsur 1993; and Estonian Ministry of Foreign Affairs 1993

Figure 4. Foreign Direct Investments in Estonia 1990-1993



1) Exchange rate 1.07.93 was 1 USD=13.5 EEK

Figure 5. FDI source countries (%) and targetted economic sectors



[7]Estonian Privatization Agency 1993

[8]Kooperationsbüro der Deutschen Wirtschaft 1993; Ministry of Finance of the Republic of Estonia

One must note that all FDI flows are not yet necessarily connected to active, functioning companies. In fact, enquiries have revealed that several joint stock companies have been established with the minimum of capital required, aiming at keeping these as shell companies waiting for a consumer market to develop. This is particularly the case of Finnish FDIs. Although the number of companies with Swedish participation is five times smaller than that of companies with Finnish participation, their share in total foreign capital is more than twice as large, which somewhat indicates the real level of active involvement and collaboration. Interestingly, those countries that are the main trading partners of Estonia, have accordingly been the most active in registrating joint ventures[9].

Additionally, FDIs undertaken in Estonia have one common feature: they are concentrated in the capital, Tallinn, where 75% of all FDIs have been allocated. This is followed by the District of Harju (11,8%) and the town of Tartu (1,4%). This can be explained by *the clearly more sufficient infrastructure, vaster number of potential customers and labour as well as by the wider spectrum of activities in these regions*. Differences between the service sector and the industrial sector naturally exist: the capital, which has a remarkably good geographical situation, is preferred among service-oriented companies and labour intensive industrial companies, whereas those industrial companies that are more resource-oriented (e.g. raw materials) prefer locating their activities near these resources. The latter holds good, though much has had to be done before these companies have been able to operate in such a location.

2.3 Foreign companies' pattern of involvement in Estonia

The undertaken interviews have revealed an evolutionary pattern of *deepening involvement* by and *increasing complexity* of foreign companies' operations all along their presence in Estonia. The different stages of Estonia's transition process are further reflected in these companies' willingness and ability to operate efficiently and with greater involvement . There were two determining interacting forces that influenced the operation form chosen by the respective companies: firstly, *prior Estonian experience* and, secondly, the *prevailing reforms*, especially in the legislative context, at the time companies entered Estonia.

The first interacting force involves the existense of a considerable amount of *beneficial relationships*, both on the firm level and on the governmental level. These relationships form a dense network in which positive contacts strenthen foreign companies' bargaining power and overall position in the Estonian economy. The ability and willingness to dialogue with the government has clearly determined foreign companies' success in their activities in Estonia,

[9]The same remark was made in two other studies concerning FDIs in the former Soviet Union as well as in Hungary and other Central-East European countries; see for this Nieminen 1991 and Borsos 1993.

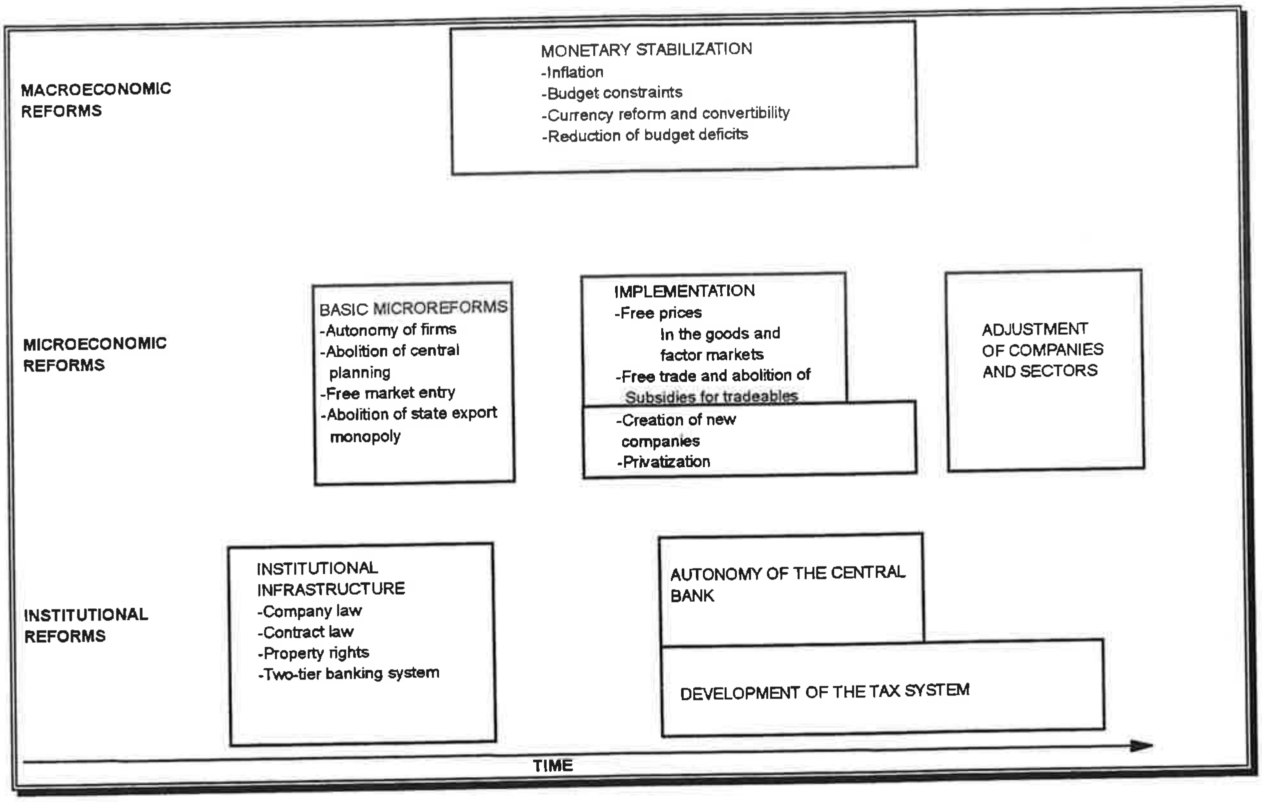
which is due to the recently started and ongoing transition process where a variety of uncertainties dominate the economic environment. Thus, both parties have mutually enjoyed the benefits emerging from these deepening and more complex relationships: foreign investors have brought their expertise, hard currencies and, in many cases, undertaken training programmes, while the government has tried to facilitate the flow of information and shared its knowledge of markets and customers. The latter also concerns foreign companies' relationships with other firms.

The second interacting force is related to the *legislative framework*, which is constantly experiencing radical changes. Other fields of reform that have to be undertaken in the transition process also strongly affect foreign companies' operations both on the macroeconomic and microeconomic as well as on the institutional level. Figure 6, on the next page, sets the basic reforms needed in the transition process. The dynamic transition process, and key reforms on the company level, have strongly affected foreign companies' operation forms and, thus, the level of FDI commitment. The various changes in the form of operation reflect the pattern of increasing complexity and deepening involvement. The steps of the evolutionary pattern were as follows:

Table 3: Development of operation forms and related FDI levels

Mode of operation	FDI level
Buyer - seller	None
Licensing	Minimal
Commercial representative office	Low
Technical representative office	Low
Joint venture	Large
Wholly owned company	Major

Figure 6: Analytical structure of the basic reforms (that either have been undertaken or will be undertaken in the future) affecting foreign companies' activities in Estonia's transition process.[10]



No firm evolved through every step of the pattern described in table 3. *Buyer-seller* relationships between Estonian and foreign companies were unnecessarily complicated in the previous socialist system. The principal feature of the communist foreign trade system was that *the state had the exclusive right to conduct foreign trade transactions*[11]. Companies and individuals were therefore prevented from directly purchasing or selling commodities in foreign markets. In the state monopoly of foreign trade system, domestic companies were permitted to deal with foreign customers and suppliers only through special foreign trade companies. When a domestic firm produced goods as part of an export plan, the goods were sold to the foreign trade company at the prevailing domestic wholesale price. The foreign trade company sold the goods to the foreign purchaser and received payment in foreign exchange. This exchange was then promtly surrended to the state bank in return for the domestic currency equivalent at the official exchange rate. The gain or loss of the foreign trade company on the deal was routinely covered by a payment from or to a Price Equalization Fund[12].

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[10]Based on the reforms perceived or considered as needed by the interviewed companies and on various writings on the topic, such as: Gelb & Gray 1991, Genberg 1991, Landesmann 1993, and Tiusanen 1993.
[11]Smith 1983
[12]Gelb & Gray 1991

The above described system was extremely inefficient as it included an *inability to adapt exports to world market conditions*. Furthermore, as a result of this system, *the producer was alienated from the world market* and manufacturing companies never developed in-house expertise in overseas marketing or foreign procurement. The only benefits, from the state point of view, of this Stalinist foreign trade model were that it strengthened the bargaining position of the state with capitalist companies, protected from foreign competition and allowed available foreign currency earnings to be allocated according to centrally-determined priorities.

Most companies chose this form of operation during Estonia's socialist period, where no FDI commitment occurred. Thus, risks were minimized. Today, these relationships are less complicated and they follow the Western model, including straightforward buyer-seller relationships. Estonian companies are often hampered by:

- The collapse of their previous major customer base (CMEA)
- A lack of knowledge of Western markets
- A lack of an export credit function by the Estonian Government

Before 1987, foreign ownership of production facilities was not permitted in Estonia. Those few foreign companies that were interested in Estonian production activities found a solution to this by using *licensing agreements*, which were at the time the most common mode of production. These agreements generally included foreign companies' supply of trademarks, quality control, basic material and packaging material, whereas FDI commitment, management and marketing expertise were not included. Foreign companies operating by licensing closely monitored the raw materials and the final products produced in order to make sure that the quality factor would not be rejected. This was necessary as quality was never required in the incentives of socialist economies. As Western goods were in great demand in Estonia, the trademark was essential in exploiting the established market and in increasing the desirability for the product. This operation mode provided:

- Reduced or avoided import restrictions
- Cost advantages from Estonia's well educated and low-cost labour force
- Reduced transportation costs
- Access to all CMEA markets (before 1991)

Founding a *commercial representative office* often followed licensing, thereby formal presence in Estonia was established. The commercial representative office enhances the possibility of subcontracting for domestic sales or export and ,generally facilitates keeping contacts with licensees and other important parties belonging to the company's network. Many of those interviewed companies that had started operating in Estonia only after 1991 chose this mode of operation to begin with in order to get better acquainted with the Estonian market and industrial environment. Some of the companies upgraded the commercial representative office to a *technical representative office* as a result of deepening relationships. This mode of operation allows the company to make direct sales, to provide customer support (after sales services, etc.) and to even further market a full range of products or services produced outside Estonia. In this step, truly market oriented activities are undertaken on the Western model.

Since foreign participation in Estonian companies became allowed by law, foreign companies have been attracted by this alternative. The reason to this is obvious: the Estonian partner knows the local market, the language and other culture bounded factors, understands the local business practices and customs and brings the opportunity to enter more easily and faster the network of local companies as well as provides knowledge of the available labour force. The contribution of the foreign partner consists of capital, management, marketing and technical expertise, as well as of providing capital equipment and a worldwide distribution network. Thus, this was the first phase in which foreign companies made FDIs to a meaningful degree. The joint venture mode of operation became, however, in most foreign companies, less common and local partners' contributions less valuable as they became established in Estonia. Furthermore, joint venture activities were sometimes considered as difficult, because of the partners' differing objectives, (particularly when the other partner was the government), or due to clashing administrative procedures, corporate cultures, and so on.

Finally, foreign companies set up independent production and marketing facilities in the form of *wholly owned companies* in Estonia. This has been possible since 1991. The majority of the interviewed companies had either totally bought an Estonian company or undertaken a greenfield operation, i.e, founded a new company. Both in the case of joint ventures and wholly owned companies, Finnish investors preferred Estonian local managers while other foreign companies had, at least in the beginning, home country managers. The difference is due to the fact that Finland is not only geographically close to Estonia, but also linguistically and culturally[13], which facilitates operating in the Estonian environment. This is why joint ventures as an operation mode among Finnish investors was more common than among other foreign investors. Moreover, the change from the joint venture mode of operation into a wholly owned company is more common in the case of Finnish companies[14]. Those companies that had gone through several phases, as described above, were more dynamic and clearly more competent;

[13] A study on the Interaction of Managerial Cultures in Soviet-Finnish Joint Ventures and Estonian-Finnish joint ventures run by Kari Liuhto (1991) ended to the same conclusion.

[14] A study undertaken by Gomez-Casseres (1985) also indicated that changes from joint ventures to wholly owned companies were more common in culturally close than in culturally more distant countries.

as a result of such experiences they were able to adapt themselves efficiently to the still ever changing industrial environment and to fully take advantage of the prevailing business opportunities.

2.4 The key driving force: new markets

The attractiveness of Estonia seems surprising, as the size of its market area is small. The reason to this phenomenon lies in the fact that the country has had a head start in fostering a positive private business environment relative to the other republics of the former Soviet Union. Additionally, Estonia enjoys the winning combination of geographic desirability as a trade route between Eastern and Western Europe, skilled labour, low wage rates, as well as considerable investment concessions and incentives[15]. The East European Investment Magazine held an opinion poll on the relative attractiveness of post socialist countries as potential hosts of FDIs in spring 1993 among 620 potential Western investors[16]. The poll comprised 27 post socialist countries, including the three countries of the Baltic region: Estonia, Latvia and Lithuania. The results were as follows:

	Total votes
Hungary	131
Poland	120
Czech Republic	94
Russia	54
Kazakhstan	32
Bulgaria	27
Estonia	**23**
Romania	22
Ukraine	22
Slovenia	13
Albania	10
Kyrgyzstan	10
Slovakia	10

	Total votes
Belarus	9
Latvia	**9**
Lithuania	**8**
Azerbaijan	5
Tajikistan	5
Uzbekistan	5
Macedonia	4
Turkmenistan	3
Armenia	2
Bosnia-Hertzegovina	1
Croatia	1
Georgia	0
Moldova	0
Serbia/Montenegro	0
Total	620

Though the result only gives an idea of the current tendencies, it clearly indicates that Estonia stands apart among its Baltic neighbours and the CIS as a whole. Analysing available information on FDIs in Estonia and the motivations of the study's case companies, it turns out

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[15]See appendix 2
[16]In Tiusanen 1993

that the foreign investor's motivations are based on the relatively well developed overall "investment climate", compared to other countries of the former Soviet Union. When considering the investment climate the following factors have to be taken into account:[17]

- Political stability
- General attitude toward FDI
- Limitations on ownership
- Currency exchange regulations
- Stability of foreign exchange
- Tax structure
- Familiarity with country

Among these factors, *political stability* is viewed as the most important element affecting FDI decisions and determining the location of facilities[18]. Prospects of market growth, the general attitude toward inward FDI of the Estonian government, as well as approaches from other companies were mentioned as other important influencial derivatives. Additionally, the so-called *"bandwagon" or derived demand effect* has become worthy of consideration: as competing firms in the same line of business have succeeded in their activities in Estonia, would-be investors have been reassured, which has led to FDIs in the long run[19]. Finally, fluid economic and political conditions in Estonia's neighbouring countries, such as Lithuania, Latvia and above all Russia, have had a significant role in the FDI decision process. The actual influence of the above mentioned factors on the activities of MNCs in Estonia are more thoroughly discussed and analysed in the respective subchapters.

The undertaken FDIs in Estonia are generally motivated by a wide set of strategic and economic considerations. The production cost factor has been an important but not a dominant FDI determinant in Estonia. For Finnish and Swedish companies cost and proximity together play an important role: a nearby production site in a bordering country provides an easily accessible alternative to domestic production. Thus, *lower production costs* go together with *low delivery and communication costs*. Most foreign investors were primarily thinking in terms of overall Baltic markets where the Estonian joint ventures or wholly owned companies are used as bridgeheads. Often, the springboard position of the Baltic states into Russian markets has also been an important reason when undertaking FDIs. However, as Russian politico-economic tensions are considered as rather problematic, Western investors are mainly

[17]Based on a classification made by the Organization for Economic Cooperation and Development (OECD); see OECD 1983.

[18]Several other studies support this fact, see Brooke 1988, Oxelheim (ed.) 1993, and Zurstrassen 1992.

[19]This phenomenon has been noticed in the case of several economies in transition,such as Hungary and Poland, as well as in developing countries; Aharoni 1966, Pfefferman & Madarassy 1992, and Tiusanen 1991.

concentrating on the Baltic area and are looking forward to taking advantage of their Estonian experiences in Russia, when uncertainties have diminished to a meaningful degree. Thus, the possibility *to enter new markets* and secure a *permanent presence and a market share* in anticipation of the region's eventual economic take-off have been important motives. Estonia is already currently used as an export base from which to exploit Western Europe's markets, even though the focus is on the FDI recipient country's markets.

Foreign investors have been particularly attracted by the *cheap and relatively well educated* labour force. The cost factor is more important in the construction industry, the high level of professional know-how is viewed as a more weighing factor in the electronics industry, whereas both factors are equally important in the textile industry. Tax allowances and concessions for foreign investors have been large, but are not relevant motives among the interviewed companies, though clear tendencies can be seen: the allowances and concessions are more important for small and medium sized enterprises than for larger partially or totally foreign owned companies. Another interesting characteristic of Finnish investors is that the offered taxation and other benefits nore grants or cheap loans offered by multilateral institutions have not affected at all their investment behaviour, and, further more, Finnish companies have not even taken advantage of these factors. Other motives are:

- To acquire a manufacturing base or raw material sources
- To learn newly developing market needs
- Increased competition in domestic markets
- To avoid cyclical or seasonal instability
- To reduce the capital cost and risk of setting up new capacity
- To enter a new field of business
- To achieve vertical integration of existing products
- To expand existing product lines

Notwithstanding the relatively good development of the Estonian business environment, there still exist a number of substantial problems, which are inhibiting an even greater optimization of FDI. These break down into *systemic problems*, which are a legacy of fifty years of central planning, and difficulties arising from:

1. Loopholes in the legislation and fast implementation of new laws - some changing the previously passed, favorable laws
2. Slow bureaucratic administration
3. Vague ownership, especially real estate ownership
4. Other system - endemic features due to the incomplete transformation into a market economy
5. The overall macroeconomic situation, especially the investment and risk climate which are not always favourable

Estonia's actions to promote FDIs have been criticized in the country, a phenomenon well known in other Eastern European countries, too, as these are experiencing a severe economic and structural crisis. In these circumstances, FDIs are considered as a threat for domestic economic activities, for national prosperity and even for sovereignty. These factors have further had a negative effect on the investment climate, and, therefore, some companies have postponed or even avoided FDI in production facilities. Other reasons include the lack of a functioning modern banking system, a poorly developed infrastructure outside the capital area, and the small market size, whose potential was reduced by the dissolution of the CMEA and the breakup of the Soviet Union.

2.5 Specific characteristics of foreign companies operating in Estonia

Though not immune to the above mentioned difficulties, joint ventures and wholly owned foreign companies have been able to perform much better than the average Estonian company. They have realized sales per employee that are higher than the average for the indigenous industry. Profits per employee and hard currency earnings, in turn, have accordingly been double the average.[20]

Foreign companies in Estonia have distinctive characteristics and objectives, which naturally attract the attention of authorities as their FDI activities have clear *resource transfer effects, trade and balance-of-payments effects, competitive and anti-competitive effects, as well as sovereignty and autonomy effects*[21]. Firstly, these companies have ownership advantages that take the form of both tangible and intangible resources, including technology. These resource transfers have had a positive contribution on the Estonian economy due to the scarcity of these resources, i.e. capital, technology and management. It is *the possession of ownership advantages* that has enabled these foreign companies to compete in Estonian markets. The ownership advantages can be classified into three categories[22]: firstly, *those that they have over other companies producing in Estonia.* In many cases they are due to the exclusive

[20]Based on the estimates given by the interviewed companies.
[21]Caves & Jones 1985, Hood & Young 1979; Lall & Streeten 1977
[22]A classification made by Dunning 1981 and 1988

possession of intangible assets, such as organizational, marketing and management skills as well as to the better resource and R&D capacity and usage than the domestic rivals. In some cases they are due to size, which in turn generates economies of scale and established position. Additionally, these companies are fully taking advantage of the skilled and low cost labour force as well as of the various government inducements, such as: tax allowances, availability of inputs on favoured terms, and easy market access (currently) due to liberal legislation. The latter generates favourable trade effects when, for instance, the established company works as an export supply point. Estonia has further benefited from the raw materials and intermediate inputs brought by foreign investors; thus the impact of FDI on levels of import and export are significant, both in relation to the balance of payments and to economic growth. As an obvious result of the ownership advantages, foreign companies have been able to reach a higher level of price or technical efficiency and /or achieve market power.

Secondly, *those that the companies achieve from many of the endowments of their parent company*, such as access to cheaper inputs, to R&D activities of the parent company and to other capacities, such as managerial, marketing and administrative services. Finally, they often enjoy the economies of joint supply in various functions (production, purchasing, and so on.). The greater the non-production overheads of these companies, the more pronounced these advantages have been compared to local and/or new firms, which have had to bear the full costs of operating in Estonia. Thirdly, *those ownership advantages that arise specifically from the multinationality of the companies* as the companies operate in various different economic environments, thereby taking advantage of dissimilar situations and factor endowments. This category is an extension of the previous ones. Multinationality has enhanced earlier mentioned advantages by offering wider opportunities in Estonia; more favoured access to markets, information, inputs; more favoured position and ability to negotiate with the government; ability to further diversify risks in different currency areas and better opportunities to take advantage of the financial support provided by multilateral institutions.

The competitive and anti-competitive effects of foreign companies on Estonia's economic performance are many-faceted, as the competitive situation in different industries varies greatly. Most Estonian industries are not as developed as in Western Europe or even non-existent, which has led to a situation where foreign companies face little if any effective indigenous competition while entering the market, and probably create a fear of monopoly. In this situation, some of the entering companies are able to engage in a variety of morbid actions, which lead to higher profits, lower efficiency, higher costs, the erection of barriers to entry, and so on. Soon after the announcement of economic liberalization in Estonia, investors using this strategy emerged. However, such investors will not be able to pursue the same strategy in the long run, as competition becomes fierce. Fortunately, most foreign investors have had long run objectives, thus aiming at creating favorable conditions for permanent presence, which in turn further enforces a more developed industrial environment for all companies operating in Estonia. It can be said that it is the entry of foreign companies that has had the effect of breaking up the cosy centrally planned market structure, thereby stimulating *efficiency and competition*. Furthermore, FDIs are mostly undertaken by companies that have already built a noteworthy position in their domestic markets, which signifies that they should have the necessary intangible capacities to allow them to earn profits on their invested capital, to overcome the emerging difficulties and to contribute to the shaping of a positive industrial environment. All of the interviewed foreign direct investors corresponded to this assumption.

In many of the cases, ultimate decision-making concerning foreign companies' activities in Estonia takes place in the home country. This involves a certain degree of loss of economic independence for Estonia, as the ability to pursue its own, desired policies in areas such as taxation, trade, etc., are reduced. However, due to international agreements Estonia has signed, and the like, *the costs of sovereignty and autonomy effects are minimal* or almost similar to those that Western European countries experience with MNCs in their territory.

The second type of advantage is that of *internalization*, which is exploited through FDI by companies that possess ownership advantages, because it is more beneficial and/or because their uniqueness is closely related to production coordination, technology or marketing skills[23]. Some companies have used internalization as a means of improving the coordination of independent activities by the exploitation of imperfections in the Estonian market. Usually, internalization is used in order to take advantage of horizontal and vertical integration. The causes to internalization are to be found in two external factors: the Estonian government and the price system. Via internalization, foreign direct investors aim at avoiding the disadvantages of disequilibria or distortion in these external factors, and at a better utilization of public goods, as well as avoiding risks and/or exploiting the economies of common governance.

Internalization has further been enforced by the government in two ways - namely, by setting the various economic policies favourable to FDIs, and, secondly, through the promotional actions of multilateral institutions, by subsidizing and supporting value-adding activities, such as R&D and other intangible assets, taking place in Estonia. Internalization advantages are particularly important in the manufacturing sector, where domestic rivals or new companies do not have the necessary endowments. Internalization further enables the foreign investors to control supplies and conditions of the sale of inputs, e.g. mainly technology , and buyer

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[23]Dunning 1981; Hood & Young 1979

uncertainty about the nature and value of inputs.; to protect and assure the quality of products, as well as to control market outlets and the use of the companies' intangible assets.

Locational advantages form the third important derivative concerning foreign companies in Estonia and explaining their willingness to undertake FDIs and accept the risk. Utilizing the previously mentioned advantages in conjunction with at least some factor inputs, including natural resources, located outside the home country brings large benefits[24] in Estonia, given the ownership advantages of foreign companies. It is *the change in the value of locational factors* that worked as a trigger for foreign direct investors, e.g. the radical economic and political changes that took place in 1991. Three factors have determined locational advantages in Estonia:

1. *The availability and real cost of resources*: lower input prices and relatively well educated labour force, economies of production.
2. *The unavoidable costs and benefits*: tax allowances and grants offered by government institutions, overall liberalization of legislation concerning FDIs.
3. *The costs of transporting products manufactured in Estonia to other countries or other regions in Estonia*: improving transportation and telecommunication infrastructure, attractive geographical location in the neighbourhood of Russian markets.

Furthermore, the investment climate and the business culture are assessed to be good enough, as both are returning towards the West and political as well as the overall economic stability are considered as satisfactory.

Foreign companies operating in Estonia have been able to make the most of their advantages by using various strategies aiming at stable and unrisky activities. The previously described step-by-step pattern of foreign companies' involvement in Estonia is one of them. Others are related to diversification, which involves the combination of activities in various economic sectors; vertical integration, which in turn takes the form of combined stage-by-stage processes through the establishment of a set of plants with foreign participation; and the concentration of activities in main cities.

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[24]Dunning 1981;

2.6 External aid to encourage Estonia's transition

After the Joint Declaration of mutual recognition between the European Community (EC) and the Council for Mutual Economic Assistance (CMEA) made in June 1988, post-socialist countries have experienced a definitive rupture from the old central-planning system. The EC emerged as a major actor in organizing aid to encourage the economic and political reconstruction of the economies in transition. In July 1989 a group of 24 countries, later called the G-24 countries, decided to coordinate their efforts under the chairman of the EC.

The G-24 was originally founded to encourage and foster the process of transformation in Hungary and Poland under the so called PHARE[25] Programme. The European Investment Bank (EIB), the World Bank, the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) are also involved in the programme. Later, support was extended to Romania, Bulgaria, the Soviet Union and Yugoslavia. Since then, the situation has changed to a great extent: aid to Romania was temporarily suspended from June 1990 on human rights grounds, financial support for the republics of the former Soviet Union and Russia are on the international economic agenda, whereas the current situation of the former Yugoslavia remains unclear. Aid has been given on specific conditions which stress the importance of the progress towards economic and political transformation. The following conditions have been set under the PHARE programme:

1. Ensuring a state of law
2. Respecting human rights
3. Establishing multipartism
4. Ensuring free elections
5. Instituting a market economy

Furthermore, the PHARE programme initially had five areas of priorities for the post-socialist countries, which were: easy market access, an increase in food production, environment, education and accumulation of investments.[26] The European Bank for Reconstruction and Development (EBRD) was founded in April 1991 in order to foster reconstruction and development in Central-East Europe. At the time, the thirty-nine members of the bank included the OECD countries, the Soviet Union and seven smaller post-socialist countries, other Western countries, the EIB and the EC as an organization[27]. The organization had the

[25] Polish and Hungarian Act for Reconstruction of the Economy
[26] Borensztein & Kumar 1991
[27] EBRD Annual Report 1992

following goals: to encourage investment in post-socialist countries, to reduce financial risks, to aid the transformation of these countries into market economies and to accelerate structural change. The bank gave priority to the promotion of joint ventures and support for small and medium enterprises. 60% of the financial aid to the country in need of it is allocated to the private sector.[28] Moreover, the EBRD recently established its Baltic office in Latvia and a loan of 73,5 million DEM has been arranged to Estonia[29], mainly for developing the energy sector.

Separate foreign loans have further been provided not only by the World Bank and the IMF, but as well by several Western governments such as Finland, Sweden, Denmark, Italy, Germany, Austria, and so on, representing a total sum of 2,2 billion Kroons. Furthermore, specific aid programmes for the reorientation of the economy have been set. the main foreign economic aid providers are Germany, Sweden, Denmark, Italy and the EC as shown in table 4. About 85% of the allocated funds were used for the organization of various personnel training programmes, advanced training courses in management, marketing, technology know-how, while the remaining 15% were aimed at covering the costs of equipment and machinery purchases.

Table 4: Amount and origin of aid programmes and available funds[30]

Aiding country	Number of projects (some still in process)	Amount of allocated funds in millions of Kroons
Italy	2	83
The Netherlands	8	18
Sweden	29	21
Germany	53	148
Switzerland	3	52
Denmark	18	83
EC	32	161
UNO development programmes	2	5

[28]Winckler 1991
[29]Kala & Vitsur 1993
[30]Based on Kala & Vitsur 1993 and on the Ministry of Finance of the Estonian Republic; unfortunately, the targetted time period during which these funds have been allocated remains unclear; these funds have probably concerned the past 1991 - 1993 period.

For neighbouring countries, such as Finland, the stable development and the reduction of development gaps naturally carry particular importance. Finnish aid to Estonia has been focusing, and will probably focus in the future too, on environmental, agricultural, transportation and training needs. Additionally, particular attention and support has been given to investment activities which advance export production.[31]

In addition to the various loans and aid programmes, several Western countries have in place programmes of *political risk insurance* that are intended to encourage foreign investment activities in economies in transition; moreover, the Multilateral Investment Guarantee Agency (MIGA) in the World Bank group provides additional programmes of the like. Programmes of international institutions further provide policy reform assistance, for example via the Foreign Investment Advisory Service (FIAS)[32]. Programmes of multilateral institutions are considered as having a significant impact on FDI flows and, thus, on the economic development of economies in transition[33]. For instance, in the case of American companies investing in countries experiencing political, social and economic instability, the "additionality" of the programmes of the US Overseas Private Investment Corporation (OPIC) played a key role in FDI decisions. A study on the issue revealed that 25% to 82% of the investments covered by the OPIC would not have been undertaken without that coverage[34]. Other studies with special emphasis on Central-East Europe as a FDI target area for Western investors have come to the same result[35].

The interviews further revealed that the activities of multilateral programmes created for Estonia's industrial reorientation are considered as an important factor facilitating the creation of dense "*issue networks*" through which companies, governmental agencies and other organizations with an interest in FDIs in Estonia participate. As a consequence, the flow of information among the involved parties and, thus, the negotiation process on the various terms of entry and operational issues are facilitated.

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[31] Kaurinkoski, Jaakko, Finland's ambassador to Estonia; based on an interview given to the Finnish Trade Review in July 1992.

[32] Which is jointly sponsored by MIGA and the International Finance Corporation (IFC)

[33] See Tiusanen 1993; Winckler 1991; Laurila 1993

[34] Young 1982

[35] See for this Tiusanen 1990, and Zurstrassen 1992

3. *The Industrial Environment*

3.1 Recent developments: Pressures for change

The present economic and strucutural crisis in Estonia mainly results from the legacy of *integration* with the former Soviet economic system. It is only very recently that the country embarked on the complex process of economic transformation towards a market-based system and greater international integration. The central-planning system suffered from its weaknesses already in the late 1960s, but the freely available Western credits in the early 1970s enabled Eastern imports to continue. As a result, reform was postponed[1]. By the 1980s, credits became more difficult to obtain and at that time republics of the former Soviet Union and Central-East European countries were increasingly dependent on Western imports for technology. A huge lack of monetary discipline (public debt 44% of GDP in 1989) and the fall in energy prices in 1986 - 1991 caused serious problems to the Soviet Union. Gorbachev's policy of Glasnost enabled the urgent need for change to be admitted.

For decades, the pace and pattern of industrial development were determined by the central planning system's needs, lacking incentives for cost efficiency. Until the end of 1989, around 80-90% of industrial output was produced by companies which were subject to administrative controls from the capital of the Soviet Union. In addition to this high degree of integration into the Soviet economy, another characteristic of the Estonian economy stands out: the *unbalanced industrial structure*[2], which was characterized by large-scale production, dependent on inputs delivered from other large-scale enterprises, often over great distances from other parts of the Soviet Union and, in turn, supplying markets throughout the Soviet Union. This resulted in an industrial structure with a high degree of dependence on links with other Soviet republics for both supplies of inputs and markets for outputs. This inevitably leads to a situation where dislocation in one part of the system quickly translates into production problems elsewhere - for instance, in the case of many specialized intermediate goods the narrow range of producers (often only one) signifies that there is little choice when an existing source of supply dries up. In a supply-constrained economy, it is the shortage of inputs that acts as the constraint on production rather than insufficient demand.

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[1]Smith 1983; Senior Nello 1991

[2]Van Arkadie & Karlsson 1992

Table 5 well illustrates the above described extensive linkages with the economy of the former Soviet Union. Around 43% of the output of Estonia's industrial sector was exported in 1990, mostly to the former republics of the Soviet Union. Chemicals were the most export intensive branch, the share of which was 70% out of total output in 1990, followed by textiles and leather, which had a respective share of 49%.

Table 5: Output and exports of the Estonian industry in 1990[3]

Product group	Total output (RUR millions)	Exports to: West (RUR millions)	Exports to: FSU (RUR millions)	Exports/Production: Non-FSU (%)	Exports/Production: FSU (%)
Chemical products	516	16	247	3,1	47,9
Textiles and leather	1468	43	719	2,9	48,9
Engineering industries	1137	25	363	2,2	31,9
Agricultural products	1633	41	507	2,5	31,0
Forest products	615	9	114	1,5	18,5
Other	825	22	517	2,7	62,6
Total	6194	156	2467	2,5	39,8

Note: excludes energy

In the short term, this degree of previous dependence constrains the options open to the Estonian economy. A quick replacement of Soviet sources of supply and the creation of alternative markets is difficult - here, *the stock - flow problem*, which arises in all economies in transition, becomes a crucial issue. The stock - flow problem that Estonia faces in its process of structural adjustment is constituted as follows:[4] Existing resources are the result of past allocation patterns. Since the criteria for their allocation and use were not market-based, past price structures and the relative closure of Estonia to world market competition would have ensured that the utilization of a high proportion of these capacities would not be viable under a new regime in which trade liberalization has taken place, prices have been liberalized and there is some rigidity in the degree to which employees accept a fall in real wages.

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[3]World Bank country study, 1993; based on data given in Estonian Trade 1991 and Statistical Yearbook of Estonia, 1991. The numbers are distorted by artificial prices and exchange rates. Exports for hard currency have consistently been valued at an exchange rate of RUR 1,8/USD; thus, the value of 1990 exports in hard currency equalled to USD 90 million.

[4]Landesmann 1993

In the case of strict application of market-based criteria, a dramatic closure of plants and companies and large-scale dismissal of workers could be expected in the short-run, which forms the so-called stock part of the problem. The flow part, in turn, arises from the fact that the building-up of new capacities and skills and even the reallocation of existing capacities which could be made viable requires substancial investment flows[5]. The generation of such funds is handicapped by the deep recession experienced in all economies in transition as well as in industrialized countries. As the accumulation of new flows is a long-term gradual process, there inevitably lies only one alternative - namely, the one where the nation is capable of maintaining a both economically, socially as well as politically sustainable level of employment and standard of living, by keeping the "stocks" in operation which would not otherwise (e.g. in a market-oriented economy) be maintained. In such a situation, attention must then be focused on the effective use of these capacities, which are unviable in the longer-run, and assuring that they do not hinder but rather support a positive process of restructuring and recovery. Thus, *the transition period often entails the following features*:[6]

- Companies which would otherwise (in a market-based system) not be viable continue to operate and losses are on the charge of various banks or the government.

- Specific linkages between companies or between companies and banks and public-administrative bodies are maintained although they should be broken off.

- Various bahavioural characteristics of enterprises will change only gradually in such areas as
  - inventory behaviour
  - employment
  - output flexibility
  - orientation of sales and sales efforts towards different markets
  - determinants of investments, scrapping of capital goods

Since the transition began, the Estonian industry has been subject to both exogenous and endogenous pressures in the following reform areas:

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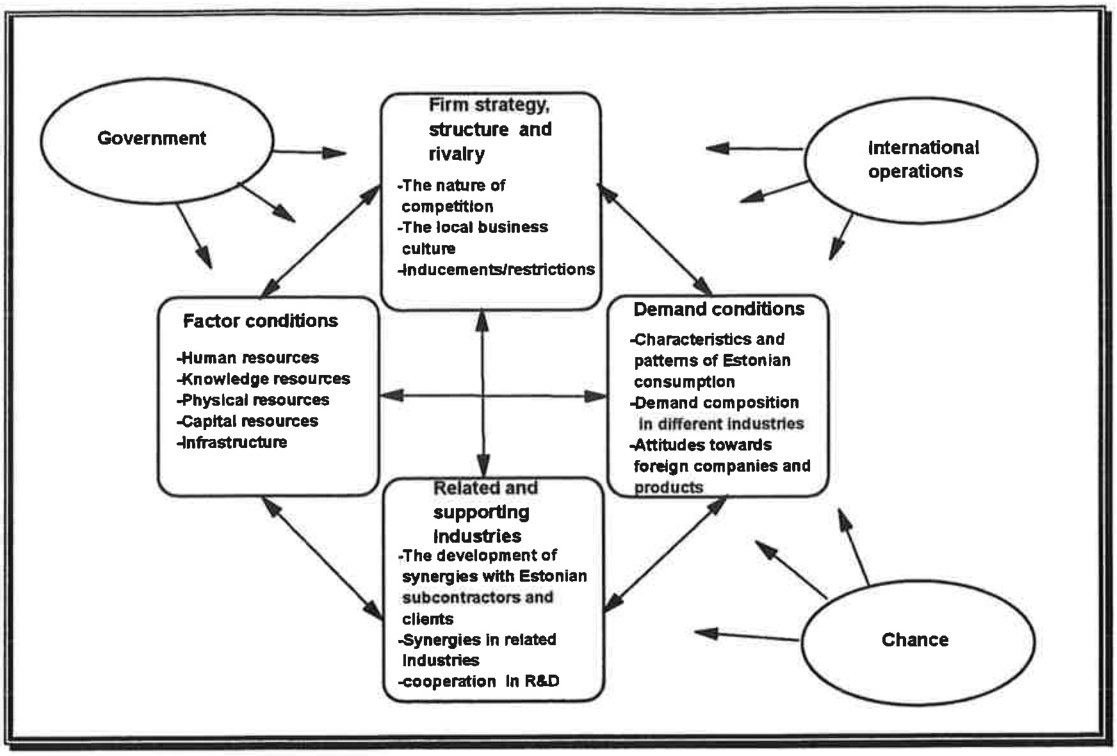
[5]Genberg 1991; Landesmann 1993; and Tiusanen 1991

[6]Landesmann 1993

1. Introducing appropriate monetary policies, foreign exchange regime and new trade arrangements, following the expected introduction of the national currency;
2. Creating the legal and institutional framework for economic transformation and market development;
3. Building up the new government administrative machinery and policies for introducing and supporting economic restructuring;
4. Privatizing, commercializing and restructuring industrial enterprises;
5. Attracting foreign investment and loan capital;
6. Acquiring and generating new technology for sustainable industrial development;
7. Developing managerial skills and export market capacities of industrial companies;
8. Gradually reducing the dominance of raw material supplies from and sales to one source and destination;
9. Adjusting operational practices of companies to market-based practices (i.e. purchases, sales, cost calculation, etc.)

These indispensable and inevitable areas of reform have also had an important impact on foreign companies' activities in Estonia. The following subchapters include a thorough diagnosis of these companies' industrial environment and their experiences according to the figure set on the next page. Topics concerning the interviewed companies are briefly mentioned within each element determining the industry's competitiveness[7]. External factors, such as the government's role in setting industrial FDI policies, are dealt in chapter 4.

[7]Porter 1990



3.2 Factor conditions

Factors of production are vital in creating a competitive Estonian industry: these comprise human resources, knowledge resources, physical resources, infrastructure, and capital. A distinction is made between inherited, existing resources (natural resources, land; e.g. physical resources) and created resources (knowledge resources), the latter being increasingly important for the success of companies and, thereby, in competitiveness as a whole.

Human resources and knowledge resources have been placed in a key position in the industrial re-orientation both by multilateral and Estonian governmental institutions. Human resources comprehend the quantity, skills and cost of personnel, (including management), taking into account standard working hours and work ethic. Knowledge resources, in turn, are used to refer to the stock of scientific, technical and market knowledge bearing on goods and services.

The economic development after World War II echoes that of the other Baltic Republics and has had a strong impact on Estonian human resources as well as on knowledge resources. There was a marked shift towards *heavy industry*, which involved *a massive influx of labour recruited from Russia.* Estonian agriculture was rapidly collectivised in the spring of 1949, after an estimated 60 000 peasants had been deported. Native Estonians were purged from the

Communist leadership in the early 1950s, since Stalin only trusted the "Russian Estonians", Communists of Estonian descent who had grown up in the Soviet Union. They would continue to dominate the Estonian party administration until the late 1980s.

In the mid-1950s, however, conditions began to improve. Some progress was made in agriculture, and Estonia was slowly opening up to the outside world, as contacts with Finland were re-established. The system of regional planning under Khrushchev benefited smaller republics, and in the 1960s living standards rose. Yet, the immigration of labour from other Soviet republics was a cause for concern, and the ethnic Estonians' share of the population decreased from 75% in 1959 to 65% in 1979. A general russification was also noticeable in administration and culture during the 1970s. Nowadays, ethnic Estonians represent 2/3 of the population, as shown in table 6:

Table 6: The shares (%) of different ethnic nationalities in 1979 and 1989 in Estonia

Ethnic Nationality	Share (%) 1979	Share (%) 1989
Estonians	65	62
Russians	28	30
Others	7	8

Foreign companies do not consider different ethnic backgrounds as imposing problems or affecting their employment policies; moreover, these companies have had rather encouraging experiences as their personnel is composed of both main ethnic groups. The reason to this can be found in the fact that their personnel was highly motivated due to the mutual benefits that all parties involved could enjoy: the more the company succeeds (in terms of profitability), the more certain it is that these people have a secured future and regular incomes, if not even increased. This way of thinking used to be totally unknown in planned economies and is now taking root at a rapid pace as the labour force is being trained and oriented towards the Western business culture. As to the language, however, foreign investors strongly pointed out that Russian was not to be used in situations where it remained unclear whether the other party, i.e. a customer, a member of the personnel or a partner, would dislike the use of the Russian language. The knowledge of foreign languages as a whole, in turn, is assessed to be relatively good, particularly in the capital of Estonia, where many of the citizens do speak Finnish, English and/or German.

Estonian legislation does not limit in any way the use of Estonian labour force in companies belonging to foreigners. The actual labour legislation is experiencing a process of continuous development as it is being shaped towards international standards, which, in some few cases, has resulted in unclear situations. As a rule, however, the state establishes the minimum requirements and the compulsory norms, while the rest is determined by the *Law on Labour Contract.*

The general educational level of the labour force is relatively high, and there is a substancial supply of skilled labour as unemployment is steadily increasing due to the structural re-orientation of the Estonian economy. Certain types of professions, however, are in short supply. These include auditors, tax advisers and customer service representatives, and, furthermore, Westren type managerial experience, although being developed rapidly, is still limited. The education of the working force is as follows:[8]

University graduates	14%
Uncompleted higher education	12%
Special secondary education	20%
Secondary education	25%
Uncompleted secondary education	21%
Primary education	8%

The good availability of skilled labour in the industrial fields covered in this study well satisfies foreign investors. Furthermore, the level of *technical* know-how and education is, according to the interviewed investors, surprisingly high. In fact, it is widely thought that the underlying potential for successful industrial transformation derives from the *technical competence of the labour force*. The relative sophistication of the Estonian economy in the Soviet context could provide the necessary flexibility to adjust to the requirements of international trade. Therefore, particular attention should be given to the maintenance and further development of formal education in the field. This is further supported by studies on economic growth indicating that long-run growth hinges in a fundamental way upon the amount of human capital and technological progress, i.e. on the labour force and the extent of know-how embodied within

[8]Estonian Statistical Office, 1993

machinery and equipment. As the economic system is being transformed into a totally different one from the planned system, on-the-job training has become crucial. Unfortunately, those companies that have the economic and intellectual resources allocated to the training of the personnel are usually foreign owned companies or companies with foreign participants that at least have an important ownership share. Fully Estonian companies are more or less dependent on governmental and other institutional aid funded for the training of the labour force. Currently, the situation is difficult for Estonian companies, as it still remains unclear *how* to participate in these training programmes and *who* or which instance actually takes the responsibility and carries out these projects. The system is much too complex for Estonian companies and will not function as long as information flows are non-existant. Meanwhile the gaps in education and know-how between foreign companies' and Estonian companies' personnel become wider.

3.2.1 Wages and unemployment

Some form of incomes policy has been introduced by all Central-East European Countries (CEECs), in part to support the weak macroeconomic control framework. A broad policy toward determination of incomes covering the public sector would be necessary even if the monetary framework were strenthened to permit reliance on market-oriented control procedures. This is due to, according to the representatives of the companies involved in the study, the fact that principal-agent relations between the government and company management are not sufficiently well structured to allow governments to rely on decentralised bargaining between employees and management[9]. The rapid increase in wages in the former GDR since the German unification serve as a warning.

Estonia was the testing ground for a wage reform already in 1987. The objective of the experiment was to decentralize decisions on wage-setting and to tie wage developments closer to changes in productivity. Even though the economic results were limited, they were instrumental in obtaining, for the first time in Estonia's socialist period, economic freedom from the centralized system for the organizations and companies involved[10]. The realization of this test can be seen as a direct forerunner to the discussions of regional economic self-accounting, and, later, economic independence. Finally, in 1991, Estonia definitely abandoned the Soviet wage system, in which salaries were determined according to a long and detailed job classification list. The new wage system icluded the introduction of various rules for setting wages inside and outside the budget sector, both implying some degree of indexation. As a

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[9]See OECD, 1992, where this argument is as well strongly supported

[10]Van Arkadie & Karlsson, 1992

result, the latter were freed from ceilings but subject to minimum compensation for price increases, while wages in the budgetary sector were linked to the minimum wage. These, in turn, were revised every six months according to changes in a basket of essential goods and services, though they were initially set by the government. Three decrees were issued in 1991 in order to make companies increase wages by a certain amount of roubles per worker.

Salaries paid by foreign companies to Estonian workers, on the average, correspond to those paid by Estonian private companies. The wage levels differ particularly in the case of executives and personnel with academic background, who earn, compared to the average wages in Estonian companies, better in foreign companies. In Western terms, the differences are naturally not as significant as in Estonian terms, and, furthermore, wages are still considerably low in Western terms for foreign investors[11]. For instance, most Finnish and Swedish companies' expenditures on wages per worker (in the operational level) in Estonia represent only 1/10 of those in the home countries, on the average.

As a result of the combination of price liberalization and incomes policies real wages have fallen sharply for the past two years, which is likely to create pressures for relaxation. In effect, estimates made by the Estonian Academy of Sciences and the interviewed company representatives give support to the latter. The most important task, according to them, is to try to maintain a stability of real wages at a realistic level, either through more efficient formal or informal incomes policies. This signifies that the growing unemployment should be cushioned by an *effective social safety net and labour market institutions*. Some foreign investors and experts even suggest that the design of policies should favour the private sector by excluding it from any wage controls; this should contribute to reducing worker resistance to enterprise reform and privatization, which is seen as one of the most serious threats to the entire reform programme. The drawback, however, is that measures like these may draw the most skilled labour from the state sector. In Hungary, this phenomenon has already taken place as budget stringency and low, compressed salary scales are inducing skilled people to leave for the private sector.

As to Estonian companies, earnings are still poorly related to education. In effect, sectors such as education, culture and health, where the amount of university graduates is the highest, are the lowest paid sectors, whereas in the construction and industry sectors, where most of the labour force has no secondary education, wages are the highest. Appendix 2 clearly illustrates the situation, though it does not include the year 1993. Furthermore, wage differentials

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[11]see also Tiusanen, 1993

between specialists, managers and workers vary by sector, but are as well very narrow on the average.

Open unemployment, which was virtually unknown in the centrally planned economies, has risen sharply due to *the fall in output, weak sales and restructuring*. At the time of Independence, less than one percent of the labour force was unemployed. By the first quarter of 1993, the level of the unemployment rate, as measured by those receiving unemployment benefits, had more than quadrupled to about 2,5%[12]. The situation is probably worse than these numbers indicate due to the complex registration system (and unusually tough criteria for classifying a worker as unemployed, compared to the Western system), which does not reveal the real unemployment level. Furthermore, one must not underestimate the diversion of workers from the official to the black market due to high payroll taxes.

Last, but not least, several state-owned companies are overstaffed and maintain a large number of underemployed workers on their payrolls, which is a heritage from the Soviet central planning system: firstly, as labour mobility was severely limited by bureaucratic hurdles and housing problems, enterprises applied for permission to employ more people than necessary to avoid labour shortages. Secondly, the main objective of the system was to assure that everyone had a work place, a policy made possible by the soft budget constraints for Soviet companies.[13] *An overhang of underutilized workers* at unprofitable companies could contribute to a further significant increase in unemployment in 1994, according to leading foreign experts.

Foreign companies operating in Estonia have been able to conduct their own staffing policies both in wholly owned companies and in joint ventures. The latter has been possible even in privatized companies that were previously overstaffed, as a result of severe negotiations with government institutions. This factor, however, has been one of the most important cause of establishing totally new wholly owned companies or joint ventures. Additionally, this strategy has further enabled these investors to avoid the extra costs involved in giving notice to the personnel, as employers are forced by law to inform their employees about layoffs four months in advance and pay compensations the following four months in case the employees do not find other jobs, and, in case they have been working for the company more than 10 years[14].

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[12]Rajasalu 1993

[13]Piirainen 1993; Tiusanen 1990; and Hansen 1993

[14]This law is in force since July 1992; see Rajasalu 1993.

Estonia has an *undersized service sector*, which is typical of the former socialist countries. This holds good particularly in the banking and insurance sector, which employs only 0,5% of the labour force in Estonia[15]. Contracting activity in large state enterprises and the growth of corporate and entrepreneurial activity will probably shift the composition of large employment away from industry and agriculture toward the service sector. For instance, it is strongly believed among foreign investors that tourism will become a more and more important sector for the country's future prosperity. Table 7 sets the sectoral division of Estonian employment in 1934, 1989 and 1993. Accurate data on employees working for foreign companies are not available, unfortunately.

Table 7: Estonia: The sectoral division of Estonian employment in selected years[16]

Industry	Employees in 1989	%	Employees in 1992	%
Food industry	30 365	13.7	24 245	15.3
Textile, wearing apparel and leather industries	44 222	19.9	38 171	24.1
Forest, wood, pulp and paper industries	30 895	13.9	13 160	8.3
Chemical industry	16 198	7.3	14 584	9.2
Building materials industry	16 204	7.3	11 752	7.5
Metal and engineering industry	68 711	30.9	40 348	25.6
Other industries	15 843	7.1	15 807	10
Total	222 438	100	158 067	100

3.2.2 The banking sector reform

Apart from privatization, building *a market-oriented financial sector* is one of the most important systemic issues faced by the transition economies. A healthy financial sector is a precondition for other key elements of the transition process[17]. The main roles that the financial sectors play in Western industrialized countries were emcompassed in the former

[15]World bank country study 1993

[16]Estonian Statistical Yearbook, 1990 and Estonian Academy of Sciences, 1993

[17]This argument is strongly supported in various publications and studies concerning the nature of the transition process undertaken in the former socialist countries; see OECD 1992, Portes 1993, Soros 1993, and Sutela 1993.

political system of Eastern European countries. In Estonia, foreign investors have particularly paid attention to the gaps still existing in the financial sector, especially concerning financial services such as *payment mechanisms* (both internal and external) and the provision of *adequate credits* at reasonable interest rates. Presently, Estonian banks give only short-term loans at a high 30% - 40 % monthly interest. Long-term loans, in turn, are rather unfrequent and non-existant. Additionally, many of the *institutions* needed in carrying out the creation as well as the maintenance of a suitable financial sector are non-existant. They are necessary in the mobilization of savings, in encouraging rational investment and resource allocation decisions by making credits available on the basis of expected profitability and ability to repay. Furthermore, they provide a source of non-inflationary finance for the government's borrowing needs.

The private sector cannot prosper without local financing opportunities and other financial services. Until now, foreign investors have been able to solve the issue by making use of their international financial networks. The presence of certain non-bank financial intermediaries could also play a positive role. Foreign investors particularly stress the following factor: Replicating many of the more sophisticated elements of international financial markets is not a high priority, but building a basic banking system capable of offering savings instruments that pay positive real interest rates and providing an effective payment system is critical. In Hungary, for instance, the financial sector's relative lack of sophistication and government imposed tight credit policies in late 1992 were still a major obstacle to the expansion of private business, which found it difficult to obtain commercial credit. The implied portfolio guarantee and continued state ownership did not provide a clear incentive for cautious lending for some of the banks.

The first financial sector reforms were already introduced in early 1988 by the Soviet authorities with the objective of establishing a two-tier banking system, which had already been undertaken by some of the European post-socialist countries such as Poland and Hungary. This reform, however, did not bring a totally Western-type two-tier banking system until 1991, when the last branch of the large Soviet Gosbank was liquidated. Several commercial banks were, anyway, established after the declaration of sovereign control of domestic issues in November 1988.

Currently, central banking, which is on the charge of the Bank of Estonia (BOE), and commercial banking functions are strictly separated. Additionally, the Estonian financial sector includes four specialized state banks. Although the Estonian banking system is underdeveloped compared to those in industrialized countries, it is considered as being more advanced than those in other Baltic countries and Russia. High interest rates on short-term loans remain a problem, as the Estonian legislation does not provide any guidelines governing security (obtaining/offering) for debt. Commercial banks, amounting to about 22 active ones[18], are now able to offer some of the needed modern services, such as running correspondence accounts in foreign banks and accepting the use of plastic money. The share of private commercial banks in total assets and credits has grown steadily since 1988. Yet, the state-owned banks (the Industry, Agriculture, Social and Savings Banks in addition to the Central Bank) dominate the system as their share of total financial assets roughly accounts for 80%[19].

The successful implementation of a currency reform that included the introduction of a new national currency - the Kroon - in June 1992, played an important role in restabilizing the country's economy, at least to some degree. From the foreign companies' point of view this reform actually captured the most significant role in deciding whether to operate in Estonia or not, as the Ruble was continuously deteriorating considerably. The Estonian government has further liberalized foreign exchange transactions to the point where the grey or black market has been virtually eliminated. The Kroon is now a fully convertible currency, subject to Western type regulations:

- The Bank of Estonia has the sole right to emit Estonian Kroons.
- The conversion of the Estonian Kroon is carried out in accordance with daily exchange rates set up by the private commercial banks in Estonia, based on the official rate of the Bank of Estonia.
- The Estonian Kroon is pegged to the German Deutsch Mark.
- The government is forbidden by law to devalue the Kroon without a parliamentary decision and is prohibited from granting credits to the state budget and local budget.
- All cash in circulation and bank reserves are fully secured by the gold and convertible foreign exchange reserve of the Bank of Estonia.

Foreign investors' experiences concerning the currency reform have been positive; the reform package was designed so that a smooth transition to the new currency was made possible, i.e, it *did not unduly disturb domestic or external economic relations*. Moreover, it encouraged trade and the exchange regime has further supported confidence in the Kroon. The Estonian

[18]Estonian Privatization Agency, 1993

[19]Based on data given in the World Bank Country Study, 1993

Minister of Finance, Madis Üürike, stated in a recent interview[20] that the main targets of the national economic programme are "to stabilize the country, to get inflation down, to retain confidence in the currency and to boost exports". There are, however, doubts on the strength of the currency among investors, as inflation is anticipated to remain rather high in 1994.

3.2.3 The infrastructure

Infrastructure as a term often entails a wide category which includes basic physical structure such as highways, ports, railways, airports, water and sewerage systems, and buildings as well as modern communication and business systems[21]. Natural resources and self sufficiency are also included in the category. Infrastructure is defined as *a fundamental requirement* when attracting FDIs, together with *political stability*. The existence of natural resources has become less important for a country's economic development. A stream of technological and organizational innovations have led to a gradual replacement of natural resources by man-made created assets as the key determinants of economic progress[22]. *The ability to produce manufactured goods or provide services is increasingly important for economic growth.* In the case of Estonia, foreign direct investors have not been dependent on the country's natural resources. As shown in chapter 2 (figure 4), most FDIs were undertaken in the industrial sector (34%), followed by investment flows in wholesale / retail trade (23,8%), transport / communication (22,7%) and real estate / business services (8,0%). The construction industry has fully taken advantage of local natural resources, whereas other industries that have possibly needed raw materials and the like, have either purchased them locally or from abroad. Until now, however, natural resources have not offered industrial opportunities for foreign investors.

In the areas of transport and communications, foreign companies are now going through a more effective period, as they have been able to adapt themselves to the situation and have found sound solutions to these issues. Transport deficiencies, often caused by inadequate transport services (and not, for instance, by the condition of roads, which actually are suitable for the needs of the industry), have forced some companies to excessive levels of *vertical integration* through the development of non-competitive transport fleets, while communications deficiencies have contributed to inadequate flows of information. The considerable decline in trade with the CIS countries had a significant impact on the 1992 freight turnover of road transport and railroads: that of the latter decreased by 70% whereas

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20 Üürike, Madis in an interview given to Järviaho, Anna-Liisa in December 1993

21 Bridgen 1993

22 This particularly concerns industrially advanced countries. Dunning 1993; see also Drucker 1986.

that of road transport dropped to one third of the 1991 volume[23]. Products destinated to Western markets were most often transported by sea. The decline in the turnover of sea transportation (8%), however, is best explained by the decreased flows of transit goods. Currently, an abundance of transit business is taking place: some 95% of freight passing through Estonian terminals is in transit to or from Russia and the other new republics[24]. The importance of the transit business must not be underestimated, as it brings in some $50 million a year to Estonia and the economic gains are expected to increase further in 1994. Thus, Estonia's geographic advantage is proving of interest to investors who are making use of Estonian factories to manufacture goods for transport to Russia and the rest of Europe. Most of the companies involved in this study actually exported their products or semi-products back to their home countries or to a third country/several countries.

The so-called "Via Baltica" project, the renovation/creation of a north-south motorway going through the Baltic countries, has attracted much attention, especially among Nordic investors. The route, extending from Tallinn to Warsaw, connects the Baltic countries to Finland in the north, Poland in the south, and further on to other Nordic and Central European countries, respectively. Thus, this 1000 km long route provides a link between Northern-Eastern and Central Europe, having then a potential to become *the main road connection serving a population of 40 to 50 million on the eastern shore of the Baltic Sea.* The roads along the Via Baltica route have been available to foreign traffic since 1988. In order to fully take advantage of the opportunities brought by the project, a five-year initial development programme of $40 million was proposed by the Finnish Ministry of Transport and Communications[25]. The development programme is additionally necessary in overcoming the main problems which, in the short term, are not related to those of extensive new road construction:[26]

1. Slow and cumbersome border procedures
2. Inadequate maintenance, including winter maintenance
3. Insufficient road-size service facilities
4. Deficient road signing
5. Road safety

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[23]Rajasalu, 1993

[24]Palu, 1993

[25]Others involved, particularly in the financing of the project, are:
the Nordic Project Fund /Nordic Investment Bank and the European Bank for Reconstruction and Development (EBRD).

[26]Revealed in a feasibility study undertaken by Martti Miettinen and completed in August 1992 for the purposes of the Via Baltica Project.

The necessity of the programme is further enhanced by the expected considerable growth in road traffic, which is forecasted to be 2 or 3 times higher than the 1992 traffic by the year 2000. Furthermore, the share of truck traffic[27] will gradually decrease representing roughly 12-17% of the total volume, whereas the volumes of international traffic, tourism and freight transportation will continue to grow at a fast pace. Transiting freight traffic flows will probably grow up to 1,3 -1,7 million tons by the year 2000.[28]

Foreign investors consider the Via Baltica Project a significant promotional factor for the whole Baltic region, as it aims, in the long run, at facilitating the development of businesses and industries in the region. The project further covers renovation and modernization of telecommunications systems, railroads, ferry connections and terminals. Thus, the scale of transport system improvements is so large that, if achieved at least partially, it should inevitably lead to positive results.

The legal infrastructure

Perhaps even more important than the constraints from lack of physical infrastructure is the problematic *legal infrastructure*, which is continuously being reshaped. Estonia has enacted a significant amount of laws designed to facilitate and encourage commercial activity. Naturally, gaps and inconsistencies persist as previous legislation was designed for the objectives of a centrally planned economy and, additionally, economic changes have taken place at a rapid pace.

Basic legal rules for business activities - such as corporate organization, codes defining and regulating commercial activities, and entrepreneurship as well as bankruptcy laws - are already in place. The free repatriation of profits, of the salaries of expatriate workers, and of capital gains is granted, although intellectual property rights are not proptected. Ownership of and transactions with real estate are covered by legislative acts, and so is the sale of land to local residents and foreigners. The latter, though, requires the possession of a specific government permit, the aim of which is to effectively allocate available land to potential future productive companies. Ownership rights, however, are found to be insufficient and would need further development. Other areas that need further legislative regulation concerning business activities, and foreign companies in particular, entail the following ones: real estate mortgage, shareholding companies' activities as well as those of commercial banks, the customs code and

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[27]Truck traffic typically formed a very high share of total traffic in the Soviet system.

[28]Miettinen, 1993

the tax system. Furthermore, the present legal framework concerning competition does not fully provide clear and predictable rules for foreign investors.

The emergence of different kinds of legislative acts, such as laws and decrees, has led to situations, where it remains sometimes unclear what exactly is *the legal basis* for a particular decision, and *how* and *where* it could be appealed against. The problem of competing and contradictory pieces of legislation has frequently been aggravated by the political process, due to the influence of various interests. For instance, the new Estonian government is currently taking a new course concerning FDI policies, the content of which still remains unknown. Thus, there is room for improvement - The most important tasks in the short term are the following ones (from foreign investors' point of view):

- The effective implementation of FDI policies
- Ensuring the coherence and predictability of the latter
- Institutional coordination of new laws
- The creation of a clear hierarchy of legal and regulatory acts introduced at various government tiers

Additionally, a review of first-generation reform laws could help improve consistency. These actions would further increase respect for the law both among local and foreign companies, some of which have had to break the rules in order to pursue legitimate business objectives due to the stifling regulations. Appendix 3 sets the current status of the legal framework as well as areas that need elaboration.

3.3 Demand conditions

Real demand declined about 5 percent in both 1990, 1991 and 1992 in responce to tighter domestic policies, the CMEA (including foremer Soviet Union) export shock and an increase in household saving. Private consumption fell in line with real GDP[29]; it did not fall more due to the fact that the 40% decline in real wages was largely offset by the transfer of income to households under the income compensation scheme. In 1990 and 1991, a turnaround in net travel flows dampened the contractionary impulses of fiscal and monetary policies, while sharply lower CMEA exports exacerbated the decline in GDP in 1991-1992. Investment recorded significant declines, as indicated by the sharp drop in the share of fixed investment in GDP: from 24% in 1990 to 15% in 1991. This phenomenon reflects, to some extent, the

[29]The share of private consumption in GDP was 64% in 1990 and 65% in 1991

absence of an advocate for capital in decentralized state enterprises. Another contributory factor was the increase in excess capacity. Furthermore, the emergence of high inflation under historic cost accounting led to an excessive taxation of enterprise profits and thus reduced companies' ability to invest. The decline in net retained enterprise earnings reduced the availability of internal financing while higher interest rates increased the cost of borrowed funds. The structure of investment has also changed significantly in recent years, in particular following the liberalization of imports of capital goods from abroad. As a consequence, the capital goods inported from former CMEA-partners or produced domestically contracted sharply.

The price reform initiated in 1990 was motivated by two basic factors. First, the liberalization of prices and the reduction of subsidies were correctly seen as a *fundamental component* of a broader program of economic reform. The price reform not only realigned relative prices but also reduced the monetary overhang and the excess demand for goods in Estonia. Second, the price reform was also a deliberate effort to *reduce spillovers* of excess demand in other areas of the ruble zone. The fear that such spillovers would continue to provoke internal shortages, despite higher prices in the country than elsewhere, led policy makers to implement other complementary measures. These included the introduction of buyer cards, coupons, and export quotas, which are not in use currently.

The faster pace of price reform in Estonia relative to the other former Soviet republics resulted in a sharp improvement in its terms of trade[30] and a shift in the trade balance from a deficit of 2,5% of GDP in 1990 to a surplus of 8,4% of GDP in 1991. In 1991, the price reform had a positive effect on entrepreneurial activities, many of which turned out to be profitable despite the general contraction of economic activity. Output prices were substancially raised while imported inputs could still be purchased at relatively low prices. Companies thus benefited directly from the gain in the terms of trade. Finally, the price reform had a positive effect on the budget, experienced through various channels: reduced budgetary subsidies and transfers, improved financial situation of companies[31], and the slower growth of budgetary expenditures (including wages) than that of revenues. It must be taken into account, however, that the budget surplus equaling to 6,5% of GDP in 1991 also reflected the introduction of new taxes that year.

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[30]Inter-republican trade accounts for the bulk of total trade.

[31]Although companies benefited from the terms of trade gain, their nominal profits were also bloated by the combination of high inflation and historic cost accounting. This resulted in the overtaxation of enterprise profits, an effect also observed in other post socialist countries (Poland).

The gains in the terms of trade more than offset the adverse effects of output contraction on the budget and on companies. The gains, together with the sharp decline in real wages, allowed companies to retain their work force, despite operating at very low levels of capacity.

Trade disruptions started to emerge with the movement for Baltic independence and were caused by attempts to avoid internal shortages, by the reluctance to accept rubles for payment, and by deficiencies in the payments system. Whereas the gains in the terms of trade in 1991 mitigated somewhat the adverse impact of the trade disruptions, the reverse happened in 1992: the price reforms in Russia and other Baltic states as well as other republics caused a sharp deterioration of Estonia's terms of trade, thus aggravating the trade disruptions. As a consequence of this deterioration in the country's terms of trade caused by the price reforms undertaken in neighbouring countries during 1992, the gains experienced in 1991 have been outweighed. The result was a net deterioration relative to 1990. The introduction of the Estonian kroon[32] facilitated Estonia's position and situation in its trade, as the ruble was continuously deteriorating, in addition to the problems created by the scarcity of the ruble.

By early 1993 virtually all prices had been liberalized, with companies free to set their own prices. The government retained the right, however, to deny or request modifications in price increases for goods from 32 companies exercising substantial monopoly power. Public services such as housing, electricity, heating, and public transport remained subject to price controls.

3.3.1 Small & open markets

Estonia is a small state with a highly opened economy. The country has made an open, unusually liberal foreign trade policy an official policy objective since Independence. Today it is one of the few newly independent states (NIS) that has implemented most of the basic policies recognized as critical for a successful transition from a Soviet-style, inward-oriented economy to one that is outward-oriented and that seeks to attain a better level of international competitiveness. Until now, Estonia has been able to quickly implement, though major challenges still remain, an outward-oriented trade policy by:

[32]See 3.2.2, p. 41 on the currency reform

- Dismantling any quantitative restrictions on trade.
- Virtually terminating state trading, promoting entry of private companies, and encouraging company-to-company trade.
- Phasing out price controls, import subsidies and export taxes, and by making imported inputs available to exporters at duty-free international prices.
- By introducing its own currency, and then maintaining it at a stable and competitive real exchange rate[33].
- And, finally, by establishing a new two-tier banking system.

As a consequence of the nation's openness and smallness, foreign trade and the development of international economic relations, as well as financial flows, have a huge impact on the nation's economic development. The previously described contraction of domestic supply and demand in the past two or three years has made the economy even more vulnerable and dependent on external factors. The path Estonia has chosen in its trade policies seems to be the right one also from foreign investors' point of view, who actually point out that this is the only solution in the light of current economic situation. The total collapse of the previous Soviet system first created a bizarre situation, where domestic rivalry was missing. Hence, this situation was somewhat *offset by the openness to international competition* and global strategies. Here, by letting foreign rivals operate in Estonia, local potential companies have had the opportunity to learn and adopt new entrepreneurial skills and operation modes related to both international and domestic company-to-company trade. New trade partners have been found and trade relationships are becoming more and more confident and sustainable.

In addition, Estonia's free trade policy has brought various other benefits: indigenous companies have access to *modern technology* embodied in imported inputs at duty-free world prices; import competition provides a *competitive discipline* on domestic companies that would otherwise be lacking because of the limited size of the domestic market and the concentration of production inherited from central planning; and most importantly, the new trade regime provides a set of *domestic prices which reflect world prices,* thereby facilitating efficient production and investment decisions.

Despite the achievement of major changes needed in the area of trade liberalization, various issues still have to be solved. These concern indigenous and foreign companies / investors both directly and indirectly. The most important factor is the already previously discussed *lack of a functioning banking system*: there are gaps in banking supervision, deposit insurance does not exist in practice, and the clearing of both domestic and international payments needs to be

[33]In the case of Estonia, an explicit depreciation of the exchange rate was not necessary, as it had already been accomplished through the open auction market for the ruble. This provided a realistic point of departure for valuing the Estonian kroon, which was introduced at the basic rate of RUR 10/EEK.

elaborated in order to be able to fulfill corporate needs. Furthermore, to sustain the already achieved objectives related to trade policy, the country needs to:[34]

- Resist growing protectionist pressures from the agricultural and industrial sectors.
- Develop enhanced access to markets in the West, including accession to GATT and intensified cooperation with EFTA and the EC.
- Increase the volume of trade with the East where this is justified economically by geographic proximity, installed capacity, and internationally competitive prices.
- Expand regional cooperation with other newly independent states in the areas of trade and investment.
- Facilitate exports by improving the operating environment as a whole (e.g. infrastructure, and the like).
- Foster a competitive environment that favors export production, particularly in industry and agriculture.

As Estonia is a small country, its demand is not regarded as large enough among foreign investors to fulfill their incentives. The Estonian market is too small for producers in manufacturing to attain minimum efficient scale and scale economies. All the companies included in the study export their products/semiproducts either back to their home countries or/and to other countries, mainly to the neighbouring Baltic countries, Poland and Germany. Surprisingly, only a few companies currenlty export to Russian markets, where St. Petersburg is the most important target market. Several foreign investors point out, however, that the objective is to reach Russian markets in the near future. Those companies that operate in consumer-oriented industries or the construction industry form an exception: the objective is to purely concentrate on Estonian markets. The reason to the fact that foreign companies' outputs in other industries are exported is obvious: the industrial customers are not yet demanding enough. In addition, one must note that potential demanding customers are almost non-existing at this stage of the economic transition. It can be stated, however, that newcomers will emerge at a rapid pace, as Estonians are considered as "fast learners".

Estonia is highly interdependent with its trade partners in Europe, characterized by the two way flows of trade and investment (though mostly inward investment).[35] Here, foreign investors have an important role to play both as investors and exporters, as they bring with

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[34]Based not only on interviews, but also (among other things): Hansen 1993; Michaely 1992; and Michalopoulos 1993.

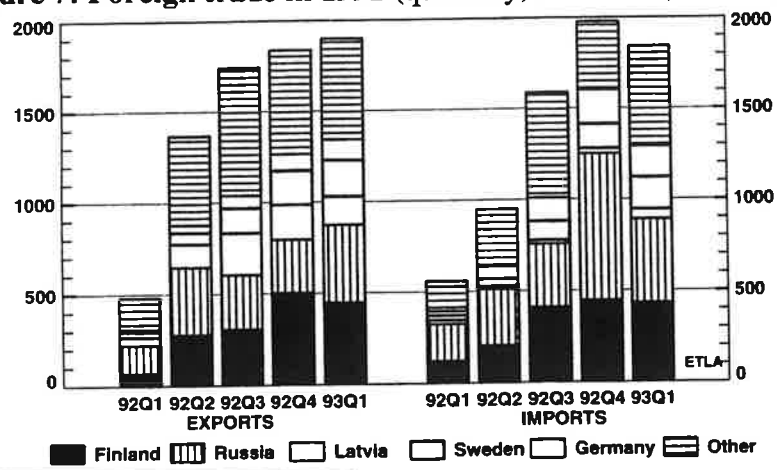
[35]See 3.3.2, which includes an overview on Estonia's
main trade partners as well as on the commodity structure

them new international trade relations and, hence, significant foreign industrial customers, which the Estonian economy definitely needs at present. Estonian industries hold a specific position in developed industrialized countries' "clusters", the multinational companies of which are relying on access to Estonia's emerging clusters. For instance, in the case of Finnish companies, integrations and linkages have been created with the emerging / few existing clusters in Estonia. Hence, in some cases, totally new clusters are introduced in Estonia by enlarging Finnish clusters abroad. In order to fully understand the nature of Estonia's structural change in its foreign trade market, an overview is taken on the main trade partners and the commodity composition of trade. First, however, the characteristics and patterns of Estonian consumption are analysed so as to reveal the large potential which lies in these markets that urgently need an efficient consumer-goods industry.

3.3.2 Estonia's main trade partners and commodity composition of trade

Prior to independence, Estonia depended on former Soviet union (FSU) trade for 95% of its exports, one of the highest dependency ratios in the grouping, whereas in 1992 well over half of the country's exports were with the West. In dollar value terms, trade with the West increased five-fold during 1992[36]. Moreover, the rapid expansion of exports to the West is even more impressive in that nearly all of this growth took place during the second half of 1992, when trade oriented to the west reached a share of over 60%. Success in restoring some of the links that were lost during the Soviet period to European markets enabled cushioning the demand shock caused by the collapse in traditional trade with the CMEA area since 1990. Figure 7 and table 8 clearly show the re-orientation and, hence, the significant change in the structure of foreign trade markets in 1992.

Figure 7: Foreign trade in 1992 (quarterly, EEK mill., current prices)[37]



[36]The margin of error in these values is large due to the substantial adjustments in prices and exchange rates in the past few years.

[37]November 1993; Rajasalu 1993.

Table 8: Main foreign trade partners in 1992 and 1993[38]

	Exports				Imports			
	1992 EEK mill.	%	**1993** EEK mill.	%	**1992** EEK mill.	%	**1993** EEK mill.	%
Finland	1152	21.2	2203	20.7	1178	23.2	3304	27.9
Russia	1115	20.5	2407	22.6	1658	32.7	2033	17.2
Latvia	586	10.8	914	8.6	85	1.7	267	2.3
Sweden	423	7.8	1010	9.5	313	6.2	1055	8.9
Germany	211	3.9	851	8	403	7.9	1273	10.7
Others	1939	35.8	3251	30.6	1432	28.3	3915	33
Total	5426	100	10636	100	5070	100	11847	100

Foreign trade flows simply halted during the first quarter of 1992 due to the missing shipments of Russian fuel that later were replaced mainly with Nordic loans and aid. Thus, that period was characterized by a heavily negative foreign trade balance. Since then, major changes have taken place, as foreign trade has actively been re-oriented toward Western markets. In addition, trade with the CIS has increased to some extent - without, however, reaching the previous level. This increase may have been caused by the domestic price increase: prices in other markets were, at the time, practically stable. Therefore, the growth of trade at current prices is close to their real growth. Hence, a considerable change took place in 1992: the share of the CIS in total exports fell from 94% to 34%, while the share of imports fell from 85% to 42%.

As a natural consequence of the structural shift in foreign trade, companies whose activities previously had concentrated on CIS markets faced serious difficulties. For instance, the substitution of cheap Russian raw materials and fuels to those originating from the West caused such a high increase in costs that it led to the closure of several companies. These companies could not continue relying on Russian markets, as purchasing power turned out to be too low. In addition, the deteriorating exchange rate of the ruble worsened the situation. Compared to Russian domestic products, Estonian ones were too expensive.

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[38]Estonian Statistics. Quarterly Statistical Bulletin 1992/4. Statistical Office of Estonia, Tallinn, 1993; Rajasalu 1993.

The bulk of Estonia's trade with the West in 1992 and 1993 was with its Nordic and other neighbours. *Finland* became Estonia's main trading partner with a fifth of total exports and imports in 1992, and trade with *Sweden* also increased substantially. These two countries maintained their position as significant trade partners to Estonia in 1993. The main trade partners to the East are Russia (share in Estonia's export: 21%), Belarus and Ukraine. The latter two countries only account for a minimal share of Estonia's total exports.

Exports to Russia and the other newly independent states in 1992 were mainly machinery, agricultural products and textiles, as well as imports consisted mainly of energy and machinery. Although this reflects patterns established under central planning with only modest consideration for comparative advantage, some foreign investors suggest that Estonia should not necessarily seek to change the composition of this trade in the short term. The extensive investments during the Soviet period in Estonia's agricultural and industrial companies were a "sunk cost" that created installed capacity that still could produce goods needed in other newly independent states. In many cases such goods have no market outside the NIS; furthermore, the goods could be produced using inputs available from the "ruble zone" at prices well below world prices[39]. Estonia could continue exporting traditional products to these markets as a transitional strategy, since the transformation of NIS economies will require many years. Any new investments in facilities to produce for markets to the East should carefully be reviewed.

Presently, Estonia's exports to the West principally consist of resource-intensive goods such as wood and furniture, as well as of labour-intensive manufactures such as textiles and clothing. Europe was the main destination for these products in 1992. Estonian companies, however, were also able to export labour-intensive products to more distant markets, such as the United States, whose share of textile and clothing in exports was 11%. The respective share of the EC was smaller. Imports from the West mainly consisted of capital goods. The total volumes of intra-Baltic trade remain small. For instance, Estonia's exports to Latvia and Lithuania account for about 13% of the total. Furthermore, a large part of intra-Baltic trade probably stands for re-exports. Estonia's major export partner within the Baltic area is Latvia, trade between these two countries mainly consists of electricity (two-thirds), chemicals, textiles and machinery. The country's imports from Latvia include cotton, chocolates, electronics and textiles. The modest

[39]John Hansen, Acting Chief in the World Bank/IFC, points out that "Estonia seems to have suffered less distortion than some of the other FSU republics in terms of the investment decisions made during the Soviet era". Estonia was a natural area for heavy industrial investment, as the country had, among other things, long standing industrial traditions with good infrastructure and a well-educated, hard working labour force with extensive industrial experience. Refering to the latter, the establishment of a railway coach manufacturing plant before the end of the 19th century works as a good example.

trade with Lithuania primarily consists of consumer goods; cotton, paper and clothing. These have sometimes been traded by barter for energy and consumer goods.

A few foreign investors point out that it is the export of electricity that can provide large opportunities for Estonia, as the country sells its electricity for less than a tenth of the prices that are common in Western countries for electricity. Since line losses limit the distance over which electricity can be transmitted economically, the market for electricity is not global, therefore present and future exports to Latvia are likely to benefit from substantial terms of trade gains. A major problem to solve, however, is the questionable legality of trade in non-ferrous metals, which forms the bulk of Estonia's East-West transit trade. The important position of the country as a center of East-West transit trade should be maintained, promotioned and problems related to it solved, as it is a significant source of revenues. The trade in metals accounts for as much as 10% of total officially recorded exports.Trading partner statistics on imports of metals show that the share is actually twice as much. Gaps in statistics between recorded exports from Estonia to the OECD and OECD's imports from Estonia still exist, unfortunately. Yet, one must wonder what kind of real volumes take place in the trade of metals and how much the state loses every day. In the future, normal trade in metals is likely to continue, even after domestic and world prices convergence, due to the fact that Estonia has long-lasted traditions in the area. Furthermore, the country simply is a major supplier of metal products, whose harbours are well-suited to receive shipments.

In the future, Estonia's liberal foreign trade policies will be threatened by the growing pressure for tariff protection from imports in the industrial sector. If the country accedes to these pressures, efforts made until now to reorient the economy toward the West could be wasted. Foreign investors are counting on the ability of the state in sustaining its credibility connected to its willingness to keep with the role of an outward oriented trade partner.

3.4 Related and supporting industries

As an increasing number of foreign firms are investing in Estonia, *synergies* are being developed as foreign and local industrial firms are becoming each other's suppliers. Such demand enables developing *specialized inputs*, such as trained labor, marketing and distribution channels, and the like[40]. Related industries are those in which firms can coordinate or share activities in the value chain when competing, or those which involve products that are complementary[41]. The step-by-step creation of new related industries in Estonia could lead to

[40]Brewer, 1993

[41]Porter, 1990

the emergence of new competitive industries. The sharing of activities can occur in manufacturing, technology development, distribution, marketing or service. The latter is of special concern in all East-European countries, as it is particularly the service component that has been lacking. The emerging related and supporting (supplier) industries provide opportunities for information flow and especially for technical interchange. Furthermore, foreign industrial companies are an important source of dynamism and change for the exploitation of Estonia's innovative potential.

As investments will mature and local as well as regional linkages will be fortified, these activities will generate additional positive spillovers, thus encouraging additional investment. Local value added should inevitably rise as established foreign companies upgrade their technology to keep up with world markets. Until now, the possibility for potential foreign investors to operate in Estonia has brought not only export and employment opportunities, but also the very much needed Western technology[42]. Foreign direct investment has made crucial production and marketing knowledge available to Estonian companies through the substitution of foreign physical and human capital for absent local factors. As local labour learns from the presence of foreign practice knowledge and equipment, *knowledge tends to become diffused* through labour mobility and informal contacts among managers. Empirical studies have indicated that investing companies are not able to hinder such diffusion: significant knowledge transfers are inevitable[43].

Estonia's industrial enterprises commonly suffer from low quality and technology standards - a reflection of the economy's former integration into the Soviet system of centralized state orders, planned production and distorted prices. In addition, much of the equipment in operation in Estonian companies has been in use for more than a decade, even though the age of the equipment does not necessarily reflect the level of technology. Outmoded technology has further contributed to poor product quality, low productivity, high consumption of raw materials and energy, as well as high levels of pollution. Even the quality control and assurance aspects during the manufacturing process were virtually non-existent.

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[42]In this study, technology is defined as the output of technological and organizational capacity, which determines the way in which tangible and intangible resources may be physically converted into intermediate and finished goods and services. The total impact of FDIs includes a myriad of both generic and specific technologies and organizational competences associated with the management of human and physical assets and the learning process, which is an inherent part of technological progress.

[43]Blomström, 1989

Foreign investors' experiences show that the introduction of modern technology has not faced overwhelming problems - at least less than expected. In effect, problems that have arisen mainly concern the "soft" part of the technology transfer, not the "hard" part, e.g., new equipment and machinery or R&D related to these two factors. As pointed out earlier in this study, the technical competences of the Estonian labour force are outstanding. Efforts have had to be made in introducing Western management techniques, especially in the following areas: optimizing means of production, production planning that would be responsive to demand changes and conditions, inventory and cost control techniques as well as means of quality assurance and control, and, finally functions related to financial management and marketing.

It is commonly approved that in Western industrialized countries technological progress can be achieved by increasing the investment in R&D or by improving the transfer of existing knowledge and stimulating the application of science in technological production processes. Given the lack of funds in Estonia, the latter alternative is appropriate when cooperation with foreign investors takes place. As Jan Timmer[44] points out: "*Technological progress is no longer considered as an extraneous factor, but rather the result of an active and direct policy by both government and private sector*". This change in view should have important consequences for Estonia, who now has several options to choose. The following methods for maximizing benefits from technology transfer well reflect foreign investors' opinions:

How to maximize benefits from technology transfer: some options available to Estonia.[45]

- Identify and set entry conditions for new and/or existing foreign investors.
- Try to eliminate restrictions on use of technology supplied by foreign companies (MNCs).
- Limit technology payments (royalties) to foreign companies.
- Reserve certain sectors for local producers.
- Specific performance requirements from foreign companies' affiliates.
- Encourage development of clusters of supporting and related activities, as well as interaction between universities, cooperative research associations and private companies.
- Impose training obligations on foreign companies.
- Improve understanding of costs and benefits of technology: improve negotiating abilities.
- Encourage foreign companies to sell technology on contractual basis.
- Give incentives to foreign companies to set up R&D facilities in Estonia.
- Solicit competitive bids from alternative technology suppliers. (continues...)

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[44]Timmer, 1993

[45]Adapted from Dunning, 1993.

- Limit duration of technology contracts.
- Encourage market structure most conducive to an efficient inflow and dissemination of technology.
- Reconsider macro-economic and macro-organization policies so as to remove structural distortions in cross-border technology markets.
- Provide fiscal and other incentives to encouraged privately financed R&D to the point where its marginal social benefits equate with its marginal costs.
- Encourage domestic production of technology.
- Encourage development of some state-owned companies.
- Support industrial restructuring and by general educational and other policies facilitate the upgrading of domestic human capital.

3.4.1 Upstream linkages: suppliers

Linkages and subcontracting arrangements between local and foreign firms are not only considered as an effective technology transfer method, but also as a way of internationalizing local companies. Foreign companies in Estonia may affect the economic welfare of their subcontracting partners and suppliers of raw materials / intermediate products in three ways. First, by the quantity of goods and services they buy from them; second by the influence they may exert on the terms of procurement; and third, by the impact they may have on the technological capability, managerial initiative and organizational competence of their suppliers.

The transactional costs involved in upstream linkages form a large part of anxiety among foreign investors. These issues are related to the possibility of disruptions to supplies, unreliability of product quality, the failure to keep to delivery dates, unacceptable price hikes and the misuse of property rights. Additionally, there are extra intra-organizational and management costs. Only a few of the interviewed foreign investors had solved the problem by actually undertaking acquisitions. The majority, however, focused on training the supplier(s). The presence of foreign companies has a significant impact on indigenous Estonian firms as they often (for the time being) buy larger quantities of output than local firms, the level of quality increases via the requirements of foreign investors, and efficiency should increase as well. There are several types of linkages, typical to market oriented economies[46], that are taking place via the upstream activities of foreign companies in Estonia.

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[46]See Halbach, 1988;
Lall, 1980; and

First of all, there are *information linkages* that take place between foreign investors and local suppliers. These comprise mutual exchanges of valuable information on market characteristics and trends, on both parties' future investment and other plans related to their operations, and on foreign suppliers of machinery, materials and components. The opportunity to get better acquainted with local regulations with the help of suppliers/subcontractees is an important advantage, as the legislative framework is continuously being changed. Foreign investors and their Estonian suppliers may also provide information about potential partners for each other. Hence, they have been able to create new, confident relationships with potential joint venture partners, for instance.

In addition to the above mentioned type of information, foreign investors have often helped in obtaining capital equipment, raw materials and other intermediate products not available locally at competitive prices. This *procurement assistance* is important for a country which is going through radical industrial changes. Structural adjustment cannot take place without adequate capital equipment. *Technical assistance*, already discussed earlier, as well as *financial assistance* have almost without exceptions been included in foreign-Estonian contracts due to the fact that these elements are needed in order to reorient local companies toward Western style operation modes . The terms of financial assistance, though, are well determined so as to avoid problems related to possible misuses. Furthermore, financial assistance is needed, as most Estonian companies do not have the funds needed in servicing foreign partners and proper financial markets are still non-existent. This type of assistance may take the form of repayable loans or concessional contributions to the supplier's risk capital, pre-financing of machinery and tools, as well as particular price agreements.

Foreign investors have had an important role in introducing a range of financial, accounting and general managerial control procedures. In addition to this *managerial and organizational assistance*, *pricing assistance* has been needed. The latter covers technical advice on the costing of products, as well as on contractual and on bargaining procedures aiming at determining prices. Other fields of cooperation embrace help in exporting to markets that are familiar to the foreign investor, assistance in obtaining sales to third countries, and the like.

Dunning, 1993.

3.4.2 *Downstream linkages: customers*

As earlier stated, the industrial/final customers of the majority of the companies involved in this study were outside Estonia. It can, however, be said that the linkages established between the few foreign companies, whose customers are in Estonia, and their industrial / business customers have had an important impact on local customers' competitiveness and innovatory capacities. For instance, the magnitude of the output produced by foreign companies in the construction industry is cuurently so large that they dominate the industry. Interestingly, many of the top construction companies have some degree of Finnish ownership, obviously due to similar building traditions and style, not to mention the favourable geographical location of Estonia. Some 70% of foreign direct investments in the Estonian building materials industry are connected to the Finnish MNC, Partek. Other Nordic countries hold a significant position in the construction/ building material industry as well. The same companies are also further expanding to Lithuania and Latvia in order to prevent the German industry from using the Baltics as a back-door into the Scandinavian market.

The interviewed foreign investors were satisfied with their industrial customer relationships, which were based on very intense cooperation. Cooperation and active day-to-day contacts played a key role in, among other things, the maintenance of control, quality and cost control. Even though the Estonian industry is under continuous development and pressure, the investors did not consider the integration of downstream value-adding activities into their own activities (e.g. own their wholesale or retail outlets) as necessary. Two kinds of linkages have been forged with local industrial customers. The first type of linkage involves advice on how to use and maintain machinery and equipment. This particularly concerns industrial buyers of technically complicated products. The second type of linkage was forged with marketing outlets. Here, the role of the foreign investor is to provide information and offer guidance about product characteristics as well as usage of the products. Hence, the "software" and servicing requirements are in a key role. Providing training facilities to customers has been the main objective of foreign investors. Clearly then, they have raised the Estonian standards of downstream activities of both intermediate and final consumers.

3.5 *Firm strategy, structure and rivalry*

Here, the context in which foreign firms are created, organized and managed as well as the nature of rivalry in Estonia are dealt. The goals, strategies, and ways of organizing firms in industries differ from those of indigenous companies. There are significant differences in management practices and approaches in such areas as the training, background, and orientation of leaders, group versus hierarchical style, the strength of individual initiative, the tools for decision making, the nature of the relationships with customers, the ability to coordinate across functions, the attitude toward international activities, and the relationship between labour and management.

Even though efforts have been made to minimize centralized control and to commercialize companies, a wide range of difficulties have emerged among Estonian companies. The knowledge and the tools necessary to make the appropriate responses to market signals are insufficient due to the fact that boards of directors and managers often lack *external information* about markets both in the West and the republics of the former Soviet Union. This also concerns prices, competitors, efficiency norms, sources, and costs of raw materials. In many of the cases, the final customers for their products were totally unknown, due to central allocation. *Internal management tools*, which are needed in the design of recovery programmes, are almost unknown. As a result, relevant and adequate information on the companies' operations are not available. The internal management tools are needed in, among other things, inventory control, cash management techniques, management information systems, cost accounting, etc. *Autonomy*, which is necessary in major management areas, is still an unfamiliar term. The most acute management areas are company reorganization, administration, labour, and wage policies as well as the sale of nonproductive assets.

These deficiencies are an inheritage of *socialistic entrepreneurship*. Companies typically had strict orders concerning resources given to them, instructions determining what they should produce, to whom to sell and at what price. State objectives limited their influence to their own business activity, which is the core reason to current entrepreneurial problems. Furthermore, monopolism led to a situation where competition did not exist. As demand continuously exceeded supply, which is an unusual characteristic in market economies, the market evidently became totally controlled by producers. In Estonia, companies were serving the needs of both their own region and the entire Soviet Union. Typically, then, these companies were too large (relative to their own markets) by size and they were often dependent on raw materials originating from other parts of the Soviet Union. Such an *artificial institutional comparative advantage* made companies overdependent on each other and, thus, their operation very vulnerable[47]. These companies usually had other functions, too. They had social obligations directing them away from their actual business activity. As a result, instead of operating as companies, they began to resemble feudal systems[48]. This system created the elite of managers, whose personal relations played an overemphasized role, whereas the indidual had extremely little influence on the companies operations. Unlimited bureaucracy flourished in the

[47]Liuhto, 1992

[48]Ibid., 1993

system. The emergence of extensive internal misuses, both among lower staff levels and management, was an inevitable consequence. This included general indifference, stealing, absences, etc. This kind of management culture did not, however, correspond Estonian national features, this is why the term "Management Sovieticus" is frequently used.

3.5.1 Ownership reform and privatization

Ownership reform and privatization are considered as core components of the overall transition process. Privatization in Eastern Europe differs fundamentally from privatization in developed market economies, where even state property functions under market constraints. In Estonia privatization is not merely a change of ownership: *it actually creates ownership*.[49] The need is obvious, as capital markets were non-existent, liquidation of companies did not occur, and control over management, albeit political, hardly existed. The main objective of privatization is to create economically independent and risk-taking units as the basic actors of a market economy[50]. In most former centrally planned economies the role of the state as owner in the business sector is to be reduced from about 90-95% to 20-30%, which is the empirical maximum in developed market economies. The following numbers clearly indicate the degree of considerable complexity in the task of creating ownership:

> By the mid-1980s, 200 large state enterprises dominated in the manufacturing industry, the majority of which were subordinated directly to Moscow. The share of state-owned companies in the service sector and transport was almost 100%, whereas the respective share in the construction industry was slightly smaller. The trade sector, however, was privilege in the sense that it was mainly, more specifically 1/3 of total turnover, in the hands of consumer cooperatives. The agricultural sector consisted of 300 farms, half of which were state farms, so called "sovhoz" and others were cooperatives, "kolkhoz". Private farms were missing, though there were households whose contribution to the production of certain agricultural products was considerable. The land as well as the majority of dwellings were belonged to the state. 1/3 of them are either private or cooperatives.[51]

Privatization is expected to *increase the amount of economic agents,* create a risk-taking management together with owners' control over it, as well as promote competition. A new

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[49]See for this appendix 4 on the main components and programmes of the privatization process in Estonia.

[50]Hunya, 1993

[51]Kein & Tali, 1993

society has already emerged as a social consequence. Ownership reform is also concerned with the difficult, sometimes impossible, task to accord justice to former owners whose property was nationalised during the socialist period. Workers who had indirect property rights under socialism, or at least that illusion, also raise special claims. Other problems emerge, as foreign investors become involved in the privatization process. On the one hand, *foreign capital is badly needed*, as internal savings comprise a very small part of the value of assets to be privatized. It would take too much time to wait until domestic capital accumulation takes place. On the other hand, *strategic and national considerations* prevent foreign influence from growing too strong. Controversy about unwelcome foreign takeover is usually confined to press and parliamentary debates and has no decisive influence on government policies. The reason to this is that the share of foreign capital is still rather small by international standards.[52]

According to Veiko Tali and Alar Kein[53], the participation of foreign investors in the privatization process has been comparatively extensive, mainly in the fields of large privatization and in the establishment of joint ventures. Some of the investors are seriously-minded long-term investors who are interested in new markets and lower production costs, while a few others are looking forward to obtaining cheap assets and even to eliminating competitors. Foreign investors involved in this study mentioned various problems occuring in the Estonian privatization process in general, which are listed in table 9. Other problems are related to the complexity of negotiations when foreign investors buy, either totally or partially, a state-owned company. The partners in privatization with foreign investment usually include both the foreign and domestic company, as well as the state agency or ministry in charge of privatization. Hence, various diversified and sometimes conflicting interests are involved in the negotiation process. The total cost of acquiring a company is high due to the complex process and the fact that the acquisition inevitably involves extra expenditures generating from the restructuring of the company.

[52]For instance, in Hungary, where privatization is most advanced, 2-3% of business assets are foreign. According to plans, the share of foreigners should amount to 25-30% by the beginning of 1995. This share is comparable to Austria's current situation.

[53]Kein & Tali, 1993

Table 9: Major obstacles to the privatization of the Estonian industry

Privatization	Rationalization of industrial structure	Management of state-owned companies (SOCs)
Lack of domestic investment resources Lack of foreign investors' interest Worker councils and management's attitude High level of indebtedness of most SOCs Legal uncertainties regarding the ownership of SOCs assets Lack of human and financial resources available to government to manage a complex process Problems of coordination between the key institutions involved	High social and economic barriers to entry and exit Financial situation of SOCs often does not reflect long term economic viability Lack of resources to manage and finance restructuring at the firm or governmental level Weakness of the Estonian banking sector Regional concentration of most acute restructuring problems	Shortage of trained personel to manage the SOCs in the new market environment Worker councils and management's attitude Complexity of the political and institutional context

3.5.2 Foreign companies' operation modes and problems related to them

Ownership strategy has traditionally played a significant role in companies' foreign direct investments. It is the degree of control the company is seeking that determines the choice of operation mode. Factors affecting the ownership patterns of companies can broadly be divided into firm-specific or country-specific factors. The latter includes, among other things, government restrictions on equity and size of the market. Firm-specific factors, in turn, include perceived political and commercial risk in the country, its relative importance to the investor, and performance requirements imposed on investors. Currently, the 22 companies included in the study either have *totally owned* (100% ownership) companies in Estonia or they operate in the form of *joint ventures*, where partners are in most cases local. Three companies that have chosen the joint venture mode of operation also have third country partners, who are Nordic.

The joint venture mode of operation has not attracted as many companies as one would think: only seven companies involved in this study have chosen that mode. As much as 12 companies had founded totally new companies (joint ventures or 100% owned firms), instead of undertaking acquisitions. One must take into account that present operation modes are mostly the result of previous experiences and activities in the country as well as of the various motivations companies had when deciding upon undertaking FDIs in Estonia[54]. There are various types of company forms in Estonia. Most of the companies involved in the study are companies limited by shares or limited partnerships. This is why only the two types are shortly discussed. Table 10 shows the differents types of company forms and the corresponding number of registered companies by type of operation mode[55].

Table 10: Forms of companies and number of registered companies in Estonia[56]

Operation mode	Number of registered companies as of Sept. 9, 1992 in the State Enterprise Register
State company	103
State companies limited by shares	185
People's companies	7
Municipal companies	179
Leased companies	204
Cooperatives	4 694
General partnerships	14
Silent partnerships	10
Limited partnerships	510
Companies limited by shares	17 573
Private companies	592
Joint ventures	322
Total	24 393

[54]See for this 2.3 on foreign companies' pattern of involvement in Estonia, page 13, and 2.4 on the key driving forces, page 18.

[55]On July 15, 1993, already 41 415 companies were listed in the register. One third of the companies created in the private sector had not, however,started their activities.

[56]The company forms in italic are those that foreign investors can choose from. The joint venture company form is not in use any more.

The legislation as such does not include the joint venture form of company any more. Most of the forms written in italic in table 11 are to be abrogated. New laws and decrees regulating the transition of these forms to joint-stock companies, partnerships or private companies have recently been adopted. As a consequence, these so-called joint ventures are now mainly operating under the form of limited partnerships or companies limited by shares, which still represent the most common type of private company activity. Joint venture as a business/economic term, however, refers to companies where there are both foreign and local owners. The minimum share capital in companies limited by shares is unusually low: EEK 300. The minimum number of shares is three, otherwise the number of shareholders is unrestricted. Limited partnerships have also been common among foreign investors, as partners involved in this arrangement are liable for the obligations of the partnership to the extent of their contribution to the fixed capital. Another important aspect of this mode of operation is that partners are not allowed to subscribe the public announcement of shares. In general, foreign investors have included this condition as an extra requirement in their agreements also in the case of companies limited by shares.

Only two of the companies that had chosen the joint venture mode of operation had minority ownership. The foreign partners, however, have a *relatively good bargaining power* in the joint venture's decision making regardless of their minority ownership. This is due to the lack of know-how and business management expertise among local executives and to the frequent use of *supplementary agreements*. The majority ownership of the local partner is, thus, only apparent. Usually, a minority ownership in a joint venture weakens the firm's power for control. Foreign investors point out, however, that majority should not lead to the disregard of the minority partner in decision-making; on the contrary, the venture should be managed as a 50-50 venture. Such a venture, however, creates the risk of stalling the joint venture's decision-making process, as clear final control is lacking. Furthermore, this mode of ownership demands great confidence and ability to cooperate between partners. In the worst situation, where complete disagreement prevails, one partner may buy out the other partner and thus solve the problems. This happened to one of the companies included in the study. In order to avoid problems that could emerge in a joint venture arrangement, foreign investors well prepared themselves to possible conflicts in the following ways:

Table 11: Anticipated risks and problem solving in partnerships

Objective	Risks	Problem solving
To operate according to legislative regulations	Local partner too influencial, potential conflicts regarding control	Management contract, well-defined terms of partnership, own managing director
Skillful personnel	Too much personnel, lack of needed capacities, unpleasant business environment affecting the joint venture, thereby preventing from the creation of corporate identity	Recruitment of only part of the personnel, training, recruitment of totally new personnel directly from universities and schools
Good marketing knowledge and distridution network	Product so different that local knowledge or distribution network not satisfying	Thorough analysis of local partner's knowledge and markets
Relationships with authorities	In case of conflict, local partner withdraws and only looks after own interests	Mutually developing and maintening good relationships with authorities
Property	Ownership arrangements unclear and becoming overvalued	Use of outside expert for estimating the real value, renting
Raw materials	Local partner in a too influencial position, holding total bargaining power etc.	Long-term contracts, building confidential relationships
Capital	The local partner has no funds to increase equity capital	Thorough clearing up of partner's financial situation

The *joint ventures* have permitted better relationships with local authorities, local competitors, local customers and even labour unions. The foreign partner enjoys the local partner's expertise in the fields of local market knowledge, cultural background, distribution network, and the local partner may also provide an insurance against expropriation risks. The latter was of particular importance earlier. Now, Estonia's situation has changed to a considerable degree during the two past years, several companies have prefered establishing a wholly-owned company or undertaking an acquisition, e.g. a greenfield investment. Risks related to *acquisitions* are considerable in Estonia. Difficulties have emerged in integrating two previously separate organizations and in turning around unprofittable acquisitions. Areas of integration problems are related to a whole range of business decisions covering strategy, management style, accounting and control marketing policies and practices, personnel and production. All of the companies had gone through these issues and were able to overcome the problems by focusing on *training and on strong internal information linkages*. Problems were mostly due to the different backgrounds of the parties involved, this is to mean that conflicts and misunderstandings thus generated from the differences between capitalist and socialist ways of thinking.

Usually, the acquisition brings a readily built market share, customer group and distribution network without having to spend too many resources for them. In the case of Estonia, and other Eastern European countries, this mode of operation has signified the undertaking of large efforts and starting from "scratch", as the existing companies' (dating from the previous system) markets, customers, etc, radically disappeared together with the old system. Only a few companies were able to maintain the previous networks. In addition, the needed changes in existing companies have created costs that could be comparable to those involved in a *greenfield investment*. This is why greenfield investments are considered as an equally good alternative. These have been appropriate when the product technology has worked as the foreign investor's competitive edge and the product demands detailed adaptation to the needs of customers. Finally, in cases where the production process technology is the special strength of the company and it is not easily transferred to the existing Estonian company, greenfield investment has come into consideration.

3.5.3 The nature of rivalry between foreign and Estonian companies

The pattern of competition in any economy has a profound role to play in the process of innovation and the ultimate prospects for international success. The impact of foreign companies' activities on indigenous competitors depends on whether the behaviour of foreign companies is fashioned by *competitive dynamics* or *monopolistic strength*. There are fears of foreign investors driving out Estonian indigenous competitors. For instance, the foodstuffs industry is already dominated by foreign companies. In the case of a transition economy, however, inward foreign direct investment is likely to *stimulate competition*, encourage a market structure conducive to the promotion of dynamic comparative advantage, and in the longer term, it should stimulate innovatory capacity.

The lack of competition in the past not only resulted in poor quality products, but also removed any incentive to be efficient in the use of inputs, such as labour, capital, raw materials or energy. Excessive costs through inefficient production were, instead, passed directly to the consumer or were covered by price subsidies. Introducing competition with the aid of foreign direct investments and by breaking up larger companies into smaller competing units, by encouraging the start-up of new companies, and by importing goods, is an important element in the transition process. In general, it can be said that the impact of the entry of foreign-owned companies into a particular industrial sector on local competitors in that same sector depends on the existing characteristics of the sector. These are:[57]

- The number and size of these constituent firms
- The composition of their output and the geography and character of the markets served
- Their innovatory capacity
- Their existing and potential economic performance
- Their entrepreneurial ethos
- The market prospects for the industry and whether or not existing firms are operating at surplus capacity
- The extent to which the industry is protected from competition

Furthermore, these variables are affected by the locational characteristics of Estonia. It seems that the ownership advantages of foreign companies have the greatest impact on local competitors, as both the intangible and tangible assets are clearly lacking among local competitors. In addition, the more foreign companies possess such advantages which can be effectively transferred or developed in Estonia, the greater the potential impact on competitors. The form of entry also has an impact, when a significant acquisition is undertaken in a fast growing sector. For instance, the acquisition of the leading Estonian foodstuffs company by a Finnish multinational led to a situation where smaller competitors are hardly able to continue their activities.

The presence of foreign compettitors, despite the above mentioned few drawbacks, are considered (both among foreign investors and Estonian entrepreneurs) as stimulating the productivity of competitors by *increasing competition, speeding up the cross-border transfer of technology (including organizational technology) and enhancing human capital.*[58] The latter takes place through the more and better training of labour, management and through partial recruitment of such resources from foreign-owned affiliates. Moreover, the responses of local competitors to the presence of foreign investors seems to be as follows:

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[57]Dunning, 1993; and Porter 1990.

[58]See Blomström,1989; Caves, 1974; and Globerman, 1979.

- A more progressive and entrepreneurial business culture
- Upgrading of product quality and performance standards
- More attention paid to management, control systems, and productivity
- Increased appreciation of education and continuous training
- Increased interest in having activities with foreign companies in order to acquire competitive advantages
- A strong willingness to internationalize as the smallness of Estonian markets has been realized

4. External Factors

4.1 The Government's FDI policies

The current debate over the impact of the inflow of FDIs made by foreign companies, often large ones, on the host countries is concentrating on two issues: firstly, on *the way in which foreign companies use their world wide assets* to achieve their long term economic goals, and, secondly, on *whether the resulting allocation of activity is consistent with that of the countries in which they operate.* These two broad issues are significant in the case of Estonia, as foreign companies are increasingly involved in problems related to the restructuring of the host economy. At best, they work as *active agents in the process of permanent and accelerated restructuring through their FDIs.* For these reasons, Estonia has chosen an open policy toward foreign direct investments. Licences are required in some economic sectors, such as in air transport and railway, commercial banking, mining, telecommunications, etc[1]. No direct restrictions have been set to foreign investors.

Various arguments exist on whether a country should have an open or rather a restrictive policy toward inward FDI. Some studies on the topic have shown that countries with a traditionally open policy for inward FDI, and countries who need the inflow of FDI *should not primarily rely on special incentives for investors*[2]. The argument is based on that foreign investors do not react upon certain incentives, if the general economic situation and the wage cost structure are considered discouraging for investment. Thus, if wages are to increase sharply in the longer term in the case of Estonia, the dependence on FDIs may have negative consequences. Attracting FDIs with special incentives (such as tax incentives and others) then should be understood as *a need to act quickly and to restore the competitivity of the economy.* Several other studies indicate that it is the general investment climate that determines the benefits/negative impact of FDIs, depending on the *political, social and economic environment.* Thus, a favourable economic environment should bring benefits from open policies to inward FDIs. Furthermore, these FDIs should also have a stimulating influence on the host country's economy. Countries with an opposite economic environment are at a risk both with open and restrictive FDI policies. The following table sets the various (inward) FDI policies conducted in different countries:

[1]See, for this 2.2

[2]Swedenborg, 1979; Van den Bulcke, 1985

Classification of different FDI policies conducted in different countries in the 1990s

Pattern 1: **Non-interventionist scenario** General encouragement to inward FDI, particularly where it is seen to promote industrial competitiveness. Few performance requirements or controls. Outward FDI increasingly seen as part and parcel of the need to penetrate foreign markets and gain assets to protect or advance the global market position of investing companies. Examples of countries pursuing such policies include most OECD countries and a few Asian developing nations.
Pattern 2: **Structural adjustment and upgrading scenario** Deliberate attempt by governments to incorporate both inward and outward FDI policies into general micro-organizational strategies - particularly as far as the restructuring of economic activity and upgrading of domestic resources and capabilities is concerned. Examples of countries pursuing such policies are Japan, Korea and Taiwan.
Pattern 3: **A selective investment scenario** Mostly adopted by developing countries which pursued import-substituting FDI policies in the 1960s and 1970s. Inward FDI confined to certain sectors; incentives and regulations imposed to ensure that such investment accords with national economic, political and cultural goals. Most of the economies pursuing this strategy, such as Latin American (except Mexico) and sub-Saharan countries African countries, still operate a largely managed economy, though in the 1980s their macro-organizational policies have become more (internationally) market-oriented.
Pattern 4: **A controlled investment scenario** As for pattern 3 except that inward and outward FDI much more stringently controlled, with many more authorization procedures involved in the setting up of new foreign subsidiaries or the acquisition of existing firms. Usually, these countries prefer foreign investors to own only a minority diect investment stake in indigenous companies. Examples of such countries are India, some Latin American and African countries. Former CMEA countries used to belong to this group. Nowadays, *Eastern European countries* and even China are pursuing an FDI policies pattern corresponding to something between pattern 2 and 3.

Foreign companies operating in Estonia have not considered its FDI policies as restrictive. Those sectors where the companies included in this study have activities are totally free of restrictions. There are some gaps in the information flows, though. For instance, it remains unclear, currently, whether tax incentives for foreign companies have been abolished or not. There is room for improvement. Thus, the most important tasks in the short term are the *effective implementation* of FDI policies, ensuring their *coherence, predictability* and *institutional coordination.* Foreign investors suggest that Estonia should *promote the efficient behaviour of both foreign and domestically owned economic units simultaneously.* This type of policy would favour a competitive domestic industry better than policies which particularly encourage foreign activities. As to the motives of the Estonian government when approving FDIs, they initially were:

- To substitute imports and thus obtain foreign currency savings
- To obtain new technology and/or technical know-how as well as management know-how
- To expand the export sector and thus obtain foreign currency savings
- To obtain foreign capital and to modernize the Estonian industry
- To introduce new goods on the domestic market
- To create new jobs, raise labour productivity, and train Estonian employees
- To increase profitability

FDI can act as a powerful catalyst for economic change, as its contribution goes beyond the entrepreneurial and financial engagements of the foreign investor. Yet, even though thousands of foreign companies have invested in Estonia and the number of projects with foreign participation is expanding rapidly, the overall volume of FDIs nonetheless *falls dramatically short of the external capital required for a rapid increase in the standard of living.* In order to attract additional investors in the growth-starved Estonia, policy-makers must be able to muster a *high degree of credibility* and there must be a preparedness to support clear, simple and market-oriented policies in the future. Until now, the country has shown a strong political commitment to democracy and the market-oriented economic system. Politico-economic relationships are working on a very good basis with Nordic countries and Western Europe, as a whole. Estonia is counting on its supporters in the West while dealing with problems related to its Russian minority.

4.2 Relationships with neighbouring countries

Russian relations with Estonia hold a special place in Russia's foreign policy of the "near abroad" for various reasons, such as: their location, their integration into the USSR as a result of the Ribbentrop-Molotov Pact , their experiences of independence between two world wars, and their active lobby in the United States. Russia's special geopolitical interests in the region are obvious: Estonian communications and ports were Russia's access not only to the West, but also to the Kaliningrad Oblast, which became an enclave[3]. Russia's interests are further enforced by the presence of Russian-speaking people and their fate after the achievement of complete independence by the Republic of Estonia. The latter is becoming a more and more crucial issue, as Russia takes advantage of the situation in order to prevent Estonia from integrating to the Western world. For instance, Mr Migranyan, member of the Presidential Council and advisor to President Boris Yeltsin, recently stated as follows:[4]

> " ....Almost across the board, Russians agree that Russians and other non-indigenous groups have become second class citizens and that racist policies are being implemented in order to push out the foreigners and to change the ethnographic balance in favour of the indigenous residents. It is absolutely clear that no government in Russia can keep from getting involved if conflicts between Russian-speaking people and Estonians and clashes on the Russian border begin."

Statements of that kind have been a source of unrest. The minority problem, which was created by rapid industrialization, is a difficult issue. Perhaps an even more serious liability is created by the presence of Russian troups. These issues have hampered both political and economic relations between Russia and Estonia. Interviews have revealed that foreign investors do not consider it as a reason to withdraw from the Estonian market. They feel confident with Estonia's efforts to make steady progress along the path of democratic and economic reform. Furthermore, the country has actively seeked to strengthen its regional relationships, above all with the Nordic countries, which actually have expressed their willingness to support the country in its claims concerning the withdrawal of the 3000 Russian soldiers. Estonia's relationships with the two other Baltic states, Lithuania and Latvia, are increasingly important as an economic free trade area is to be established in the near future. Politically, closer ties are being pursued in the very same issues.

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[3]Migranyan 1994

[4]Ibid.

The recent approvement of the Partnership for Peace membership in NATO is also considered as a factor clearly indicating Estonia's willingness to join the European political and economic community. Investors point out that this gesture further fosters Estonia's positive economic development, as the political risk involved with operating in Estonia is reduced through a more favourable investment climate. One must note, however, that the programme does not provide the usual guarantees of defending through military means, if necessary. The investors are counting on its "mental" effects. Finally, the interviews clearly indicated that Estonia is considered as the most reliable FDI host country in the region. Yet, they remind that the security of the Baltic states is the "touchstone" of European integration.

4.3 Economic relations with the European Union

Following the economic and social collapse of communism, close cooperation with the European Community and its support seemed particularly important. The "back to Europe" drive has been viewed as one of the elements in the transition of Estonia, along with democratisation and the establishment of a market-oriented economy. The so-called Visegrád group (the Czech Republic, Slovakia, Hungary and Poland) has signed European Association Agreements with the European Union, which should lead, if fully implemented, to considerably decreased trade barriers by 1997[5]. Estonia is also looking for further cooperation and new agreements. It has even actively shown its willingness to join the European Union as a full member, which foreign investors do not consider as a very probable event.

Even though the European Union has been under severe criticism for denying market access to exports from the transition economies through its various anti-dumping measures, quotas, safeguards, sectoral agreements, tariffs and variable levies, the situation is still far better than a few years ago, according to foreign investors. For instance, average tariff rates on imports from the Visegrád countries last year dropped to 1-2% from 6-7% in the early 1990s. In fact, these countries have better access to the European Union markets than non-European OECD countries[6]. Accents have lately been shifted in the way Western European countries, particularly Germany, look at their Eastern neighbours. The political motives have become less important than the economic ones. Foreign investors also point out that new protectionism could lead to unfavourable consequences in Western Europe. Western Europe would be

[5]Kaminski, 1993.

[6]Ibid.

threatened by waves of immigrants and the continent by a lack of stability, if the transition ends up in a failure or a long-lasting crisis.

Foreign investors view the Estonian market as a source of competition, not only as big sale markets. They consider free trade with the Baltic states and Central-East European countries as an important factor in Europe's objective to regain global competitiveness vis-à-vis NAFTA and the Far East. The essential criteria are that these competitors have the advantage of low-wage areas that allow the efficient distribution of labour. Secondly, this would lead to the restructuration of those parts of European industry that suffer from overcapacity and inefficiency. Competition from Eastern Europe plays, thus, an important role in creating overall efficiency. In fact, recent studies indicate that the European Union and EFTA countries have *far more to gain than to lose* from opening up their markets. In 1992 both had trade surpluses of $ 19 billion with Eastern Europe. Given the still relatively low levels of trade, some economists estimate that Western exports could increase by more than 10% annually for over a decade before stabilizing at a normal level[7]. This kind of export expansion will signify *considerable job creation* in the West, not to mention adding significantly to GDP growth.

The central idea in the arguments given by the interviewed foreign investors is that, in the long run, revenues and jobs are lost in the competitive export-oriented sectors when protecting the so-called sensitive sectors, such as agriculture, steel, textiles and chemicals. Actually, it is exactly the idea of the restructuring advice (focusing on liberalization measures) that Western experts have been giving to many of the Eastern countries, including Estonia.

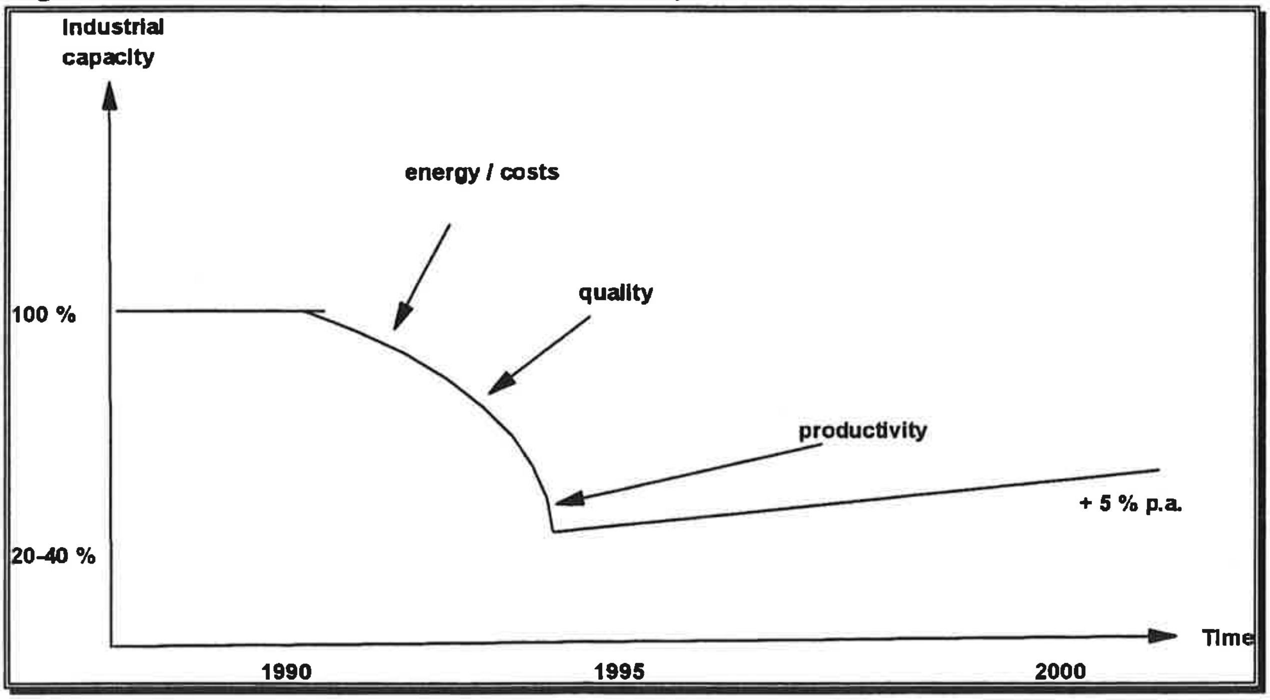
[7]Meth-Cohn, 1993

5. *Conclusions*

5.1 Challenges & opportunities

The Estonian industry is characterized by a severe structural crisis, faced by the so-called stock-flow problem discussed in the third chapter. Industrial production has collapsed mainly due to disruptions in trade with the former Soviet republics and present Russia, the lack of knowledge of Western markets, and overcapacity as well as inefficiency of the industry. These break down into unavoidable cost, quality and productivity problems, as shown below.

Figure 8: Characteristics of the Estonian Industry



The change for domestic companies has been radical. They are forced to evolve quickly to become competitive in a free-market environment. They face not only increasing domestic competition, but also competition from abroad either directly or through imported products.

The industries developing most rapidly are insurance, banking, economic and commercial services, which formerly did not contribute significantly to gross domestic product. The foodstuffs, textile and construction industries are rapidly developing as well, due to the considerable amount of foreign investors in these sectors. The presence of foreign investors has enforced the path of positive economic development. Changes will gain a more permanent nature as the indigenous industrial and technological base gradually improves. For Estonia, whose neighbours are suffering from severe political and economic problems, the presence of foreign companies *rather secures than limits its independence and future position in Europe.*

The contribution of FDI does not only comprise offering financial resources, bringing new technology, management and marketing knowledge as well as access to foreign markets. It also entails the contribution to creating a corporate business culture, and, thus, helping in reshaping the attitudes of a population that has not been confronted with a foreign (non-Russian) presence for a long time. Thus, their presence is considered a stimulating the productivity of Estonian competitors by *increasing competition, speeding up cross-border transfer of technology and enhancing human capital.*

From the company point of view, Estonia is the ideal location for investment in the Baltic region, as the country has had a head start in fostering a positive private business environment relative to other republics of the former Soviet Union. Additionally, it is considered as more stable both economically and politically than its neighbouring countries. This is why many of the foreign companies have chosen to serve other markets by establishing their presence in Estonia. The needs of the Estonian market as well as those of the surrounding markets are huge. Furthermore, Estonia is also used as an export base from which to exploit Western Europe's markets.

Several factors are favourable for Estonia whilst choosing the location for foreign companies' activities, relative to its neighbouring countries. Foreign investors have been attracted by the cheap and relatively well educated labour force. The possibility to enter new markets and secure a permanent presence and a market share in anticipation of the region's eventual economic take-off have been important motives. Many of the investors are looking forward to taking advantage of their Estonian experiences in Russia, when uncertainties have diminished to a meaningful degree. Thus, the springboard position of Estonia into Russian markets has also played an important role when undertaking FDIs in the country. The investment climate as a whole is favourable enough to attract FDIs.

Notwithstanding the relatively good development of the Estonian business environment, there still exist a number of substantial problems, which are inhibiting an even greater optimization of FDI. These problems are mainly systemic problems, which are a legacy of 50 years of central planning, and difficulties arising from, among other things, loopholes in the legislation and the fast implementation of new laws, slow bureaucratic administration, vague ownership, and other problems generating from the incomplete transformation into a market economy. The following table sets the country-specific considerations in Estonia according to foreign companies' ownership, internalization and locational characteristics.

Table 12: Country-specific considerations in Estonia

Ownership	*Remarkable factor endowments*: + good availability of labour force + low cost, well educated labour force + labour force reoriented toward the West, motivated and fast at learning - increasing unemployment - falling standard of living - inefficient, non-productive state-owned entities *Government inducements for FDI* + liberal legislation allowing foreign activities + tax allowances for foreign companies + medium-sized privatization processing - otherwise slow,unclear privatization process - legal framework continuously changing
Internalization	*Government intervention* + policies encouraging FDIs + political and economic reforms + repatriation of revenues not restricted, and the like *Adequacy of infrastructure* + communications improving fast in the main cities + good ability to absorb resource transfers, in the fields of marketing, management, and accounting - local financial and banking systems not well developed, but + increasing foreign currency holdings + stable national currency

Location	*Investment climate & environment* + good political and economic stability + consensus for change among political parties + actively seeking to rejoin Western markets - some domestic ethnic problems (Russian minority) - possible friction with Russia over Russian troops - strong concern about political instability in Russia - small domestic markets + attractive geographical location

Hence, Estonia faces major challenges in the near future:

- *Accelerating structural change.* There are clearly many areas in which momentum in microeconomic or structural change needs to be advanced, particularly in the areas of privatization, a functioning banking system with adequate credits, and dealing with the still unbalanced industrial structure.

- *Adapting the fiscal structure to a market-oriented economy.* One of the highest priorities of the government is to further reform the tax system to provide enough revenues for government operations. Traditional sources of revenue (from the state-owned industries) have plummeted, while potential new sources of revenue (personal income or profits in the private sector) have so far evaded proportionate taxation.

- *Dealing with the social frictions caused by rising unemployment.* Estonia will probably experience rising unemployment as an inevitable effect of industrial restructuring. In the longer run, higher unemployment could well develop in tandem with enhanced productivity and positive overall economic growth. Social unrest can be a major problem hampering economic and political stability.

- *Trying to increase the export momentum in the face of a revitalizing European economy.* Here, international cooperation and actively seeking to create good economic relationships with the European Union are key factors.

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Tax concessions applying to companies with foreign participation in Estonia

I

If the foreign investor's share in the fixed capital of the enterprise at the beginning of and throughout the taxation period is at least 30% but not less than $ 50 000 or the equivalent value in another foreign convertible currency, the enterprise is exempt from income tax for a period of two years, commencing with and including the first year a net profit is realized. In the subsequent two years, income tax will be decreased by 50%.

II

If the foreign investor's share in the fixed capital of the enterprise at the beginning of and throughout the taxation period is at least 50% but not less than $ 1 000 000, or the equivalent in another foreign convertible currency, the enterprise is exempt from income tax for a period of three years, commencing with and including the first year a net profit is realized. In the subsequent five years, income tax will be decreased by 50%.

Average wages by sector in Estonia (current rubles)

	1970	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991 Jun-Sep
A. Excluding Subsidies and Fringe Benefits													
Total State Sector 1/	135.3	188.7	192.8	196.4	200.6	208.3	215.1	221.0	229.0	249.2	270.1	340.7	586.4
Material Sphere	140.6	197.3	202.6	207.5	210.6	220.0	226.9	234.2	242.2	262.7	287.7	358.1	590.4
Agriculture	119.4	171.5	172.6	177.1	181.6	186.6	195.8	199.9	213.0	235.2	273.2	357.0	681.6
Industry	146.7	204.7	209.1	214.0	216.6	224.6	232.2	237.3	246.2	268.0	292.6	359.8	678.7
Construction	166.9	226.4	234.2	241.3	247.3	260.6	267.2	275.7	292.5	318.1	354.1	454.4	717.6
Trade & Catering	104.5	146.0	148.1	146.7	149.6	156.4	160.4	165.3	168.9	187.7	215.1	305.8	544.8
Forestry	106.8	161.1	165.0	168.2	173.3	176.8	180.9	183.1	193.2	209.3	211.4	241.5	387.6
Transport & Communication	150.6	212.1	217.1	220.6	226.5	231.8	236.8	242.7	256.7	277.3	291.6	363.4	573.2
Data Services	103.4	165.1	166.6	170.8	175.8	187.2	178.8	193.8	199.6	226.3	285.3	356.9	570.9
Storage & Stocking	119.4	171.5	172.6	177.1	181.6	186.6	195.8	199.9	213.0	235.2	273.2	357.0	681.6
Other	96.2	130.2	131.1	134.0	136.1	141.6	139.4	150.2	150.8	167.5	174.2	246.4	457.9
Non-Material Sphere	119.8	166.2	167.4	172.5	175.2	178.8	185.9	187.6	197.3	216.6	229.8	318.8	501.1
Education	111.1	145.4	147.3	149.9	150.6	155.5	163.4	168.3	180.8	192.0	192.9	240.1	426.0
Health	99.1	141.7	145.7	146.6	146.7	145.2	147.1	149.3	157.0	183.7	179.9	252.1	459.5
Housing Services	106.6	162.5	162.5	164.9	172.3	177.9	181.3	185.6	191.3	202.5	216.7	270.8	466.4
Transport & Comm.	134.7	195.6	199.6	203.8	208.8	213.9	218.2	226.0	239.6	258.4	272.6	335.6	537.5
Sports	120.1	149.8	154.3	157.8	156.4	150.1	221.1	160.8	166.5	176.5	181.5	282.2	514.3
Social Maintenance	87.8	127.1	130.4	130.4	125.8	125.9	131.3	129.3	136.2	151.9	166.1	255.2	
Culture	96.8	146.3	137.8	139.1	146.7	148.7	150.3	143.4	148.9	159.6	177.8	243.7	462.4
Art	116.8	163.5	166.2	169.6	158.0	163.3	164.8	190.0	199.1	199.0	210.5	373.3	409.2
Science, Research & Dev.	134.0	184.3	190.6	192.9	197.4	199.2	203.9	208.4	221.4	251.1	306.1	392.1	553.8
Banking & Insurance	110.6	165.2	166.9	166.1	172.0	181.5	187.0	199.1	207.8	225.1	250.1	469.3	737.4
Administration	127.2	170.2	172.9	176.4	178.2	181.3	191.1	194.3	199.1	224.5	285.5	376.7	581.8
B. Including Subsidies & Fringe Benefits 2/													
Total State Sector 1/	183.7	263.0	270.2	278.7	285.6	298.2	308.7	313.5	330.4	362.0	393.1	489.6	
Collective Farms													
A. Excl Subsidies & Benefits	126.2	206.6	214.3	227.1	246.0	265.8	272.7	283.5	291.1	304.9	317.6	351.5	
B. Incl Subsidies & Benefits	298.2	307.3	319.3	339.9	364.0	374.4	391.8	400.5	422.7	439.4	491.3		

Source: Estonia Statistical Office.
1/ Without collective farms.
2/ Other than paid vacation.

Current Status of the Legal Framework and Areas that Need Elaboration - Commercial Law, Property Rights and Competition Legislation[1]

Commercial Law, including contract law, banking law, and related judicial rules.

Existing codes (pre-World War II) set forth general governing principles , but need to be adapted to be relevant and helpful in the new, complex, market - oriented system. Current transactions frequently do not fit easily into the older structures. A Banking Law was introduced in December 1989 and it is being further elaborated.

Areas of elaboration comprise legislation governing the sale of goods, credit transactions, secured transactions and collateral, negotiable instruments, as well as securities.

Property Rights, including ownership rights, property transfers, and collateral possibilities.

Existing laws affirm rights to private property in the Property Law (June 1990). Restitution of property owned prior to World War II, as well as basic principles concerning municipalization, privatization and renationalization are governed by the Law on Property Reform (July 1991). There are also laws on Joint Ventures (April 1990), Foreign Investments (September 1991) accompanied with a Law on Tax Incentives for Companies with Foreign Capital (September 1991). A Law on Privatization of State-Owned Service, Trade and Catering Facilities (December 1990) came into force, followed by amendments in May 1992 and in July 1993 (Law of the Republic of Estonia on Privatization). The latter stipulates the terms and conditions of the privatization procedure of state enterprises and other state property. In spring 1993, a law allowing foreign investors' purchases of land in Estonia was passed.

Areas of elaboration and / or enactment of legislation and regulation include: (a) the recording of titles, transferring, and mortgaging or otherwise encubering the property; (b) the precedence of local and central government claims on state-owned property; (c) regulations and the implementation framework governing compensation and other aspects of restitution; and (d) effective privatization.

[1]Based on interviews, the World Bank Country study (1993), the Estonian Academy of Sciences (1993), and the Estonian Privatization Agency (1993)

Competition Legislation, including entry and exit, trade, and the control of monopolistic practices.

Existing laws - the Enterprise law (November 1989), the Statute of Shareholders' company (November 1989), and the Statute of Economic Associations (June 1990) - allow the creation of various types of business entities under a variety of ownership forms. The law on Leasing (October 1990) permits private operators to use state-owned assets. The bankruptcy Law was passed in June 1992.

Areas of improvement include anti-monopoly laws

APPENDIX 4

Main Components and Programmes of the Estonian Ownership Reform[1]

I New business operation forms

- Reorientation of entrepreneurship through the emergence of new cooperatives, joint-stock companies, partnerships, etc.

II Clarification of ownership rights to nationalized property

- Nationalization (incl. partial renationalization of property of state cooperatives and public organizations)
- Commercialization (reorganization of state-owned companies into state-owned joint-stock companies)
- Municipalization (incl. remunicipalization)

III Pre- and / or semiprivatization

- Delegation of ownership rights - establishment of people's (collective) companies
- Leasing of integral property and companies (incl. the establishment of lease enterprises)
- Establishment of joint ventures
- Reorganization of small state companies
- Partial sale of shares and extension of state joint-stock companies' share capital (banks, etc.)

IV Privatization

- Establishment of private farms
- Small privatization (Book value up to EEK 50 000)
- Extended small privatization (less than EEK 0,6 mill.)
- Small privatization via municipalization
- Pilot privatization of 7 large companies
- Large-scale privatization (incl. the privatization of agricultural products processing industries)
- Privatization through bankruptcy
- Spontaneous privatization
- Privatization of dwellings
- Land reform
- Ownership reform of state and collective farms
- Reprivatization (restitution, replacement, compensation)

[1]Based on Kein & Tali, 1993

E L I N K E I N O E L Ä M Ä N T U T K I M U S L A I T O S (ETLA)
THE RESEARCH INSTITUTE OF THE FINNISH ECONOMY
LÖNNROTINKATU 4 B, SF-00120 HELSINKI

Puh./Tel. (90) 609 900
Int. 358-0-609 900

Telefax (90) 601 753
Int. 358-0-601 753

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