



THE FUTURE COMPETITIVENESS OF THE EU AND ITS EASTERN NEIGHBOURS

Proceedings of the conference

Edited by
Peeter Vahtra and Elina Peltó

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Foreword

In the course of globalisation, competitiveness has become a guiding word not only for companies but for nations as well. In 2000, Europe's heads of state and government declared their intention to make the European Union "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion." In order to achieve this goal by 2010, the Lisbon Strategy of political and economic reforms was adopted. However, the future competitiveness of the European Union depends not only on the development of member states but also on the development of the Union's neighbouring countries.

The conference "Future Competitiveness of the EU and Its Eastern Neighbours" organised by the Pan-European Institute of the Turku School of Economics on September 1-2, 2006 aimed at outlining the future development of the enlarging EU in terms of competitiveness and the Union's relations to its neighbours, especially to the largest one, Russia. This publication consists of 15 selected conference papers covering several themes from foreign direct investment and relocation of industries to corporate governance issues in the European context.

The book starts with keynote articles by Rector Tapio Reponen of the Turku School of Economics, and Professor Kari Liuhto, director of the Pan-European Institute of the Turku School of Economics. Both keynote articles discuss the current challenges of developments in globalisation impose on European countries, and stress the importance of international cooperation in dealing with those challenges. However, as Liuhto points out, one should keep in mind that competitiveness is not a goal in itself but rather a means to increase welfare. Furthermore, competitiveness should not be considered as a one-time project but as an ongoing process requiring proactive measures.

The first section of the book consists of two papers concerning the prospects for competitiveness of the EU and Russia. Building competitiveness in Europe requires political will, suitable policies and co-operation. These are addressed in the first article discussing the future of EU-Russian relations, especially concerning the Partnership and Cooperation Agreement (PCA), Energy Dialogue, and Common Economic Space. The second article assesses the impact of EU enlargement on the Union's competitiveness in the world market and concludes that the impact in general has been positive. However, the competitiveness of EU-15 against the new member state seems to depend on the country groups.

Relocation of industrial production has become topical in many European countries especially as the new members enter the Union. The three articles in the second section of the book discuss the issues related to industrial relocation in the enlarging Europe, both from the perspective of the new member states and from the old ones. The conclusions show that whereas many countries in the region are to emerge as winners in international relocation of industrial production, several European countries are facing a real threat of losing out under tightening global competition.

The third section of the book deals with issues related to foreign direct investment, including the investment attractiveness of the new EU member states, FDI and its impact in Ukraine, and FDI's cultural spillovers in the Baltic Countries. Experiences of foreign firms in Central and Eastern European markets are discussed in section four by two papers. Attention is paid to the challenges of the changing institutional and business environment during transition. Acquiring local knowledge and adapting to local conditions has been a key to success for foreign firms in these markets.

The last two sections concentrate on company and industry development in Central and Eastern Europe and Russia, the largest neighbour of the EU. Section five includes three papers discussing corporate governance issues in Russia and the Baltic Countries. Attention is paid to earnings management, financial transparency and state control over enterprises.

Finally, section six concerns the development of production systems especially in Russian industrial sectors, emphasising the viewpoint of a foreign investor.

By tackling the variety of issues topical to the development of the competitiveness of the EU and its Eastern neighbours, the conference has contributed to our understanding of many of the actual challenges of the region in the face of increasing global competition. By promoting active discussion on new areas and methods of co-operation between the EU and its Eastern neighbours, we hope to have contributed to the future development of the competitiveness of the region. We would like to thank all the conference participants for their valuable role in this process and welcome new readers to familiarise themselves with the interesting conference themes put forward by the current volume.

Turku, January 2007

Peeter Vahtra and Elina Peltö

Keynote addresses

Wider Europe in global competition

Tapio Reponen
Rector
Turku School of Economics

In business life there are many interesting trends at the moment. Over the last decade leading companies have moved from multinational to global operations. There is a more recent trend in the increasing demand to link locally customized services with the economies of scale that result from worldwide operations. One management challenge is to cope with this new customer need.

We are also living a time of relocating production according to the level of production costs and logistics. Recently also research and development activities have been outsourced. In this context a wider Europe has a lot of potential to be a competitive and successful economic region.

In the environment of continuous change both research and practical actions are needed. This conference calls attention to the tradition and perspective of cooperation between countries in different parts of Europe. The weak signals show that regions may hold a stronger position in the future than they do today. A competitive region is, however, cooperation between several countries, not within a single one.

In this development a natural cooperation between European countries has a lot of potential. Finland is a country of early adoption and even pioneering use of technological innovations. We hope to continue to be an important technology implementer, but more emphasis will be placed on marketing of innovations. In this way we have the potential to be a good partner in Baltic cooperation.

The Turku School of Economics provides research and higher education in the field of business science. We conduct both basic and applied research and offer graduate, postgraduate and adult education. Expert consulting services form an increasing part of our activities.

The school's key areas also bear relevance to the themes of this conference. Our Pan-European Institute is a leading unit in Finland in the study of Baltic Sea Economic Region, especially Russia. All Europeans are important collaboration partners in its operations. We have an active role in promoting a wider Europe and supporting its success.

A note on competitiveness

Kari Liuhto

Professor, Director

Pan-European Institute¹

Turku School of Economics

Competitiveness is a frequently used word within the realm of European discussion since the launch of the Lisbon Strategy six years ago. The noble goal of this Strategy is to make the European Union the most competitive region in the world by 2010. The mid-term report of the Lisbon Strategy, however, reveals that this objective cannot be reached without stronger commitment to its goals. What should we commit to?

Even if competitiveness has been at the heart of the European discussion for years, we sometimes forget that competitiveness is not a final goal, but rather a powerful means to achieve rising standards of living and increasing social welfare.

We also tend to forget that competitiveness is a relative concept. The absence of an absolute level of competitiveness begs the question of how much growth and what kinds of growth are needed to secure our competitive position against the rapidly developing companies of the emerging economies.

One could also ask is the global competitiveness building a zero-sum game. In other words, does the increasing competitiveness of the Asian firms lead to decreasing competitiveness here in Europe or can we all become more competitive via closer co-operation.

One should keep in mind that competitiveness is no longer measured in a national competition but in global championships, and hence, one has to be competitive globally. This requirement does not only apply to large corporations but to all companies, since globalisation reaches all the corners of the world with tremendous speed.

Competitiveness is not a project but a continuous process, as a firm or a nation must be competitive at all times since the modern Business Olympics are held daily and not only in every fourth year. This stresses the leaders' capability to manage competitiveness. In other words, it stresses their capability to build and maintain competitiveness in a sustainable manner through decades instead of quarters of a year or election periods. A requirement to be competitive through decades underlines the flexibility of firms and the flexibility of the economic structures surrounding them. Furthermore, managing competitiveness requires proactive measures since reactive measures usually come too late.

*"The competitiveness of people, whether part of a nation, of a firm, or as individuals is the most fundamental competitiveness factor for creating wealth. The eagerness to succeed and the willingness to work hard are irreplaceable qualities to attain higher levels of competitiveness. ... A major revolution is now underway: emerging economies are not competing any more with cheap manpower but also with cheap brainpower. Russia has one of the largest R&D personnel worldwide; India is renowned for its scientists and Central Europe for its engineers. ... The war for the best talents, globally, has gained unprecedented importance in firms."*²

¹ Homepage: <http://www.tse.fi/pei/e>

² A quote from Professor Stéphane Garelli, The World Competitiveness Landscape in 2006, IMD World Competitiveness Yearbook 2006, p. 50.

Though copying the best performance may be a short cut in improving competitiveness, one cannot become the most competitive only by imitating others, and therefore, considerable investments in research and development and innovations are required. Investments in R&D and innovations mean, in practice, that competitiveness building tends to be expensive. Though building competitiveness is expensive, one should keep in mind that the decision not to invest in competitiveness building is, ultimately, dramatically more expensive in long run.

Even if it is clear that considerable investments are required to improve competitiveness, there is no universal recipe regarding where to invest, when to invest and how much to invest. Though it seems self-evident that investments should concentrate on projects creating something new instead of on targets merely maintaining the status quo, this is not always the case when political rationale becomes involved in decision-making.

Rome was not built in a day but one should remember that some parts of it were, and therefore, even smaller actions are needed to maintain and improve competitiveness.

A less competitive administrative environment with strong red tape, corruption and an unequal enforcement of the law does not only distort competition within a nation but it also reduces the global competitiveness of the firms suffering from this malaise. Even if a competitive administrative environment cannot guarantee the competitiveness of its firms, the non-competitive administrative environment certainly guarantees that the firms cannot ever become the most competitive in the global business game.

The absence of a commonly accepted measurement of competitiveness makes its development complicated. Return on investment is a rather useful method to measure the competitiveness of a firm, but the competitiveness of a country is a much more complex issue.

A country may increase its GDP but the growth does not necessarily mean that the country's competitiveness has improved. For instance, if the growth is based on natural resources and their favourable price development, the economy may grow quickly without a significant improvement in competitiveness, as the country merely sells its assets abroad without modernising itself.

Similarly, GDP per capita does not take into account the country's ability to distribute the gained wealth in a fair manner. Furthermore, GDP per capita does not consider the country's ability to provide its citizens with good living conditions, security and various freedoms. A system lacking the aforementioned fundamentals should not be considered as competitive even if it would happen to be effective in value creation.

Finland ranks very high in competitiveness studies. Although Finland stands high in these ratings, even Finland should keep in mind that today's competitiveness was built on the decisions and actions of yesterday. One should continue with the same breath that yesterday's recipes do not necessarily guarantee success in the future. Therefore, new technologies and new ways of doing old things better should be sought for.

One of the main goals of this conference is to search for solutions of how to build the future competitiveness of the EU via more diversified co-operation with our largest eastern neighbour, namely with Russia. I believe that Finland, the Finnish firms and our universities may contribute to the building of competitive synergies between the Union and Russia.

Section 1

Prospects for competitiveness of the EU and its neighbours

EU-Russian relations in view of 2007: A problematic search for a concept of new economic relations

Tatiana Romanova³
St. Petersburg State University

Abstract

The EU and Russia are currently searching for the new basis in their relations trying to solve the so-called 2007 dilemma. The paper starts with the analysis of the progress in the relations so far. Due attention is paid to the energy relations of the parties and to the Common Economic Space as illustrations of deep divergences in how Moscow and Brussels see the future of their cooperation. It then addresses the views of the two sides on how to develop the relations with priority attention given to economic cooperation and gauges each set of views against the conceptual differences between the parties.

³ Ph. D. in Political Science, associate professor at the Department of European Studies, School of International Relations, St. Petersburg State University. romanova@dip.pu.ru.

Introduction

EU-Russian relations are currently at their critical point. On the one hand cooperation between the partners has been much enhanced since 2000. Such initiatives as the Energy Dialogue, Common European Economic Space and four common spaces have been launched. The level of trade has increased a lot. On the other hand the real down-to-earth cooperation stalled and most of the initiatives were not supported by more specific activities or private parties' actions.

Currently cooperation is complicated by the so-called 2007 problem. It stems from the fact that the Partnership and Cooperation Agreement (PCA) that forms the legal basis of EU-Russian relations was concluded in 1994 and entered into force in 1997 with the clause that it would be in force for the period of 10 years and automatically renewed year after year "provided that neither Party gives the other Party a written notice of denunciation of the Agreement at least six months before it expires". (Partnership and Cooperation Agreement 1994. Article 106.) So, in fact there is no risk of legal vacuum in 2007 after the end of the initial period of the PCA.

However, the Russian side decided to use "the year 2007" marker as an opportunity to drastically change the EU-Russian relations because it believes that both the parties and the world environment have changed a lot since the early 1990s when the PCA was designed and hence the legal basis of the relations between the European Union and Russia should be transformed. Moreover, the 2007 marker is viewed in Moscow as an opportunity to change the currently painful and irrational relations devoid of working institutions and specific time-structured indicators. This view was not shared by the European Union in general and Brussels officials, in particular. The latter believed until recently that the majority of the PCA clauses was still valid and had to be implemented before parties decide to change the legal basis of their relations.

However, after a protracted discussion it was agreed at the October 2005 EU-Russian summit that negotiations on the new treaty between Russia and the European Union would start with the public discussion and consultations with the private stakeholders with later development of an agreement that would be adequate to the current state of the two partners and to their wish to develop closer relations. Moreover, it was decided that an expert dialogue would be launched to create special conditions for the EU-Russian relations in the new environment and to "optimize" the existent institutional structure (Zayavlenie dlya pressy Prezidenta Rossii, 2005). The determination of the British EU presidency to launch early consideration of the new treaty (The UK Presidency of the European Union, 2005) contributed to the final decision.

Most recently at the May 2006 summit in Sochi the leaders discussed the future EU-Russia relations after the expiry of the first period of validity of the Partnership and Co-operation Agreement (PCA) in 2007. They looked forward to the start of negotiations for a new agreement which should provide a comprehensive and durable framework for the EU-Russia strategic partnership and agreed to allow the PCA remain valid until a new agreement enters into force (17th EU-Russia Summit. Sochi, 25th May 2006).

Hence a new EU-Russian treaty increasingly becomes a political reality of the bilateral relations and the centerpiece of all future discussions. Still the views of the two partners on the prospects of their relations and on the treaty that is under the discussion are quite divergent. To make things even more difficult there is no single point of view or a clear concept on how to develop the bilateral relations either in Brussels or in Moscow.

The divergent views of the parties on 2007 problem reveal, on the one hand, the difference in how Russia and the European Union (and different stakeholders inside these actors)

approach bilateral cooperation and, on the other hand, the lack of conceptual vision of both Russia and the European Union. In the rest of the paper I will explain these two things primarily addressing the complexity of the economic relations of the two partners.

I will start with the brief outline of the PCA and progress in the implementation of its economic provisions until present time paying particular attention to the conceptual difficulties that surfaced in the Energy Dialogue and development of the Roadmap for the Common Economic Space. I will then examine the options of the future of EU-Russian relations that are discussed in Russia and in the EU. The paper will conclude with the sketch of possible scenarios of EU-Russian relations in the short-term and long-term perspectives.

Results of the PCA Implementation

Some General Comments on the PCA

The PCA has been a strange treaty since its very early days. This is reflected in at least three things. Firstly, it was designed on the basis of the so called European agreements that were aimed at the preparation of the countries of Central and Eastern Europe to membership in the European Union. PCAs that were worked out for the countries that emerged on the territory of the former Soviet Union contained many clauses on the reform of the economic and political systems along the lines of the European Union but they did not contain the fundamental carrot that worked for the countries of Central and Eastern Europe and helped them to cope with the difficulties of this sort of transformation, there was no prospect of future membership in the European Union for the PCA-partners of the European Union. To make things worse TACIS, technical assistance programme to Russian and most post-Soviet countries, (unlike the PHARE for the Central and Eastern Europe) did not reinforce the PCA priorities and initiatives until the beginning of this century. In fact, the fundamental goal of those treaties was not to integrate the post-Soviet countries but to contain them and guarantee that no threat to the European Union emerged from their territory. The demand on the transformation of economic and political systems was placed in a very unilateral manner and no benefits were offered in exchange.

Secondly, PCA provisions have never been well balanced. Most of its clauses are on economic cooperation which reflected the type of EU relations with the world at the beginning of the 1990s. However, because Russia was not a market economy at the time of the conclusion and is still not a WTO member, most of the PCA provisions are about vague cooperation with no specific goals and measurable indicators. The second and third pillars of the European Union (on Common Foreign and Security Policy and on Justice and Home Affairs) were in their early days at the time of the negotiations on the PCA and therefore were not adequately reflected in the Agreement. Russia, which is traditionally interested in the political cooperation, experienced a very romantic period in its foreign policy and as a result rather passively followed the suggestions of Brussels. Moscow did not insist on the insertion of clauses on the economic transactions that was feasible and in the interests of Moscow. Russia's interest in the cooperation in the field of external security as well as in the field of justice and home affairs was virtually not reflected in the text of the agreement either.

Thirdly, the institutional structure of the relations was modeled after the EU's structures and the institutional architecture of Brussels' relations with any third-country. It included regular high-level meetings (summits), meetings of the ministers (Cooperation Council) and meetings of the medium-level officials (Cooperation Committee and its sub-committees). However, this structure did not reflect the specificity of Russia with its bad knowledge of the EU's structures and institutions as well as low possibility of independent decisions at the level of officials. Therefore, the layers that are the most efficient in the European Union, i.e. medium-level officials and experts, virtually did not work in EU-Russian relations. It is

noteworthy that a recent file of the Russian Ministry of Foreign Affairs says bluntly that the Cooperation Committee and its sub-committees virtually do not work (Rossiya-Evropeiskii Souz, 2006). As a result most of the decision-making was either pushed upwards or stalled.

The Russian attitude to the European Commission has consistently been quite cautious. It demonstrated a certain fear of something that Russian officials did not understand properly, of the technocratic European Commission. Moscow's efforts to constrain its influence either through arguing for the limitation of its role in designing the agenda of EU-Russian relations or through the cooperation with some member-states (notably, France, Germany, Italy but also some others) to defy the competences of the Commission have been quite persistent.

The influence of the private parties (that normally play an important role in the development of the EU's relations with the third countries) in the form of the EU-Russian Roundtable of Industrialists have become sound only recently with the change of the principle of their formation from cooptation of companies to the open membership. Their real input is hard to estimate by now. The influence of the newly established dialogue between the UNICE and the Russian Union of Industrialists and Entrepreneurs (RUIE) also remains to be seen.

Despite these deficiencies the PCA was fully ratified by all the parties by 1997 and has been in full operation for nine year by now. In fact, the PCA implementation can be divided into three stages. At the first stage that lasted from 1994 to 1997 the parties tried to test only economic provisions of the treaty on the basis of the temporary agreement because the whole PCA was not ratified by all EU member states. In reality this period was used to get to know each other better.

At the second stage (from 1997 till 2000) Russia and the European Union examined different options of cooperation from a free trade agreement in the economic part of the treaty to political and security dialogue. Not much was achieved at this stage but parties became familiar with different cooperation instruments and institutions and got to know each other better. This was also the time when the initial goal of the PCA, the formation of a free trade area was put aside because the parties understood a wide difference between them.

The real efforts to enhance cooperation, to test different models and to come to a qualitatively different type of the relations came only at the third stage of cooperation of the two parties after 2000. Many events caused that transformation. Among them were the change of political leadership in Russia (but also in Brussels), the enlargement of the European Union, through which most Central and Eastern European countries were incorporated to the Union and the EU-Russia border was substantially extended, as well as perspectives of Russia's membership in the WTO to name just a few facts. That transformation at the third stage led to the multiple new initiatives in EU-Russian relations. Let's look at the two key economic projects in more details: the Energy Dialogue and the Common Economic Space. The aim of the analysis is not to present a detailed picture of the cooperation on these two initiatives but rather to demonstrate the conceptual difference between the parties.

Energy Dialogue

The Energy Dialogue was the first initiative launched at the third stage of the PCA implementation to intensify the relations. The goal was to create a firm link between a major supplier and a key consumer of the energy resources (primarily oil and natural gas). The interests in this dialogue were reciprocal. Russia wished to guarantee itself the so called security of demand, i.e. to guarantee that the exported amount of oil and gas will be purchased by the EU's consumers at the price that is acceptable for Russian suppliers. Furthermore, Russia was interested in the export of processed energy goods to the

European Union (like electricity or nuclear materials) and in the direct access to consumers. The European Union wished to guarantee the security of supply, in other words it wanted to be sure that the needed amount of oil and gas is provided to the consumers. Furthermore, the parties decided to facilitate the flow of EU investments in Russia and the exchange of practices and technologies in energy efficiency and energy saving.

The idea of the Energy Dialogue was officially presented at the EU-Russia summit in Paris on 30 October 2000.

The European Union and Russia have decided to institute, on a regular basis, an energy dialogue which will enable progress to be made in the definition of an EU-Russia energy partnership and arrangements for it. This will provide an opportunity to raise all the questions of common interest relating to the sector, including the introduction of cooperation on energy saving, rationalisation of production and transport infrastructures, European investment possibilities, and relations between producer and consumer countries (Joint Declaration, 2000).

The progress in most of the topics of the Energy Dialogue was slow and was traced in the so-called progress reports that were prepared annually (and sometimes twice a year) by the group of high-level coordinators (Mr. V. Khristenko and Mr. F. Lamoureux until the beginning of 2006 and Mr Khristenko and Commissioner A. Piebalgs since then).

The European Union's position was dominated by the wish to spread its legislation on liberalization of energy relations on Russia. This position of Brussels can be easily explained by the fact that Russia is the chief supplier of oil and gas to the European Union and hence it influences many processes inside the EU in the field of energy. In particular, the process of energy liberalization and, more specifically, the right of EU consumers to choose their supplier cannot be guaranteed unless there is a choice of suppliers in Russia and other major importers of oil and gas to the European Union. Thus the easiest way of actions for the European Union has been to insist on the spread of its legislation on Russia. It boiled down to the reform of Russian energy sector along the lines of the reform in the European Union with the division of the energy supply chain into exploration / generation, transport and distribution. It would also include the rise in internal energy prices in Russia.

This view was reflected in multiple documents. After a long discussion of the two sides the demand was a bit moderated and it now says that

... the principles of the internal energy market, such as energy efficiency, reform of internal industrial structures, reform in the electricity sector and unbundling, could provide part of the reference framework for the restructuring of Russia's energy sector. Even if the two markets are separate, they should be inspired by shared principles (European Commission, 2004c).

Russia, on the other hand, tried to preserve the independence of the regulation of its market, and the gradual process of the reform. Furthermore, it has been concerned with the liberalization of the energy sector in the European Union because it created a potential threat to the security of demand. Since the 1970s Russian gas export has been based on the so-called long-term contracts and the liberalization of natural gas in the EU undermined these contracts and eventually led to their drastic change (abolishment of the destination clause and cut of duration). In return for these changes in the contracts the Russian side asked for the direct access to EU pipelines and to consumers in the European Union, which was officially granted. However, when Russian companies tried to exercise this right they faced

the opposition of EU member states. In particular, the spring 2006 debates about Gazprom's investments in Great Britain are noteworthy.⁴

Thus Russian efforts to maintain its positions in the EU's markets were opposed by the European Union and its member-states. The underlying idea of Brussels has been that one cannot pick and choose the benefits of liberalisation of the EU's market without changing the nature of their home market. A partner country should, according to Brussels' officials, either liberalise their energy sector and take both the benefits and the negative sides of liberalisation or stay away from the market and limit themselves to the mere export of raw materials with no tangible stakes in the EU's market. The very fact that the internal reforms of the European Union fundamentally transformed the nature of import contracts (and that Russia has already taken some negative results of the liberalisation) was not adequately considered. What is even more curious, the EU's side tried to politicise the conflict to explain its negative position on Russian investments.⁵

Russia's efforts to enlarge the export of electricity to the European Union as well as to change the regime of nuclear materials export did not progress too far either. Two facts explain this. One is that EU markets for these products are highly competitive. Another reason is that Russian products constitute a serious threat to EU producers because of substantially lower productions costs. Therefore, the EU's markets have been protected from relevant Russian goods since yearly 1990s and the PCA's obligations to consider these regulations and to change their nature have not been fulfilled.

Thus, to sum up the European Union has so far insisted on unilateral approximation of Russia's legislations with the EU's one. It did not consider the fact that the regulation that was developed for its members may not suit other countries or that liberalisation has already profoundly influenced trade in energy goods between Russia and the European Union. Only on the condition of legal approximation and reciprocal opening has it been ready to open its market for Russian companies. Russia has tried to preserve the independence of its regulation and at the same time favourable conditions for its export as well as the equality of partnership. It also has searched to guarantee open regime for the processed energy goods. Under the Russian pressure the European Union has moderated its demands but also limited the possibilities for the actions of Russian companies in the European market.

Common Economic Space

The idea of a common economic space between Russia and the European Union dates back to the early years of the PCA. Already this agreement presupposed the eventual formation of a free trade area between Russia and the European Union. At that time the goal of EU-Russian economic relations was quite clear in terms of integration theory – a free trade area with some approximation of the legislation of the two parties. The relevant obligations were fixed in the PCA. However, very soon it became evident that a free trade area between Russia and the European Union was not possible in the near future because of the slow pace of the reform in Russia, slow WTO accession negotiations and because of the unwillingness of the European Union to allow competitive Russian goods into their market.

⁴ At the beginning of 2006 Gazprom's executives speculated on the possibility of increasing Gazprom's role in the British market. Following speculations about Gazprom's acquisitions, British secretary of trade and industry A. Johnson in cooperation with some colleagues held several meetings to explore the options of how to prevent Gazprom's alleged acquisition of assets of British companies. This was an extremely difficult task because since 2002 any public interference into mergers and acquisitions based on political reasons were prohibited in the United Kingdom. According to the *Financial Times*, which published the information on these consultations, Mr. Johnson eventually came up with some sort of a possible solution. Publication of this information provoked a vehement reaction on the part of Gazprom and its head Mr. Miller urged EU member states that if they prevented Gazprom's investments the gas supplier would look for other partners in different parts of the world.

⁵ Some EU officials insisted that Gazprom's acquisitions might create a serious political leverage of Russia inside the European Union. Others drew parallels between that situation and the gas conflict of Russia and Ukraine at the beginning of this year. The European Commission, for its part, rushed into reminding Russia of its supplier's obligations.

Eventually it was decided to form something different that later became known as a common economic space.

A common space is a strange thing from the economic point of view because it is not clear whether it is more or less than a free trade zone or a custom union, or how it relates to the common market. The Concept of the Common European Economic Space, which was initially under the discussion (since 2001 till 2003) foresaw “an open and integrated market between the EU and Russia, based on the implementation of common or compatible rules and regulations, including compatible administrative practices, as a basis for synergies and economies of scale associated with a higher degree of competition in bigger markets” (Joint Press Statement, 2003). In essence, it would include the freedom of movement for goods, services and capital as well as a very limited freedom of labour movement. This obscurity in economic terms was preserved in the Common Economic Space, which together with the three other common spaces subsumed the Common European Economic Space and was approved in 2005. The unwillingness of the parties to define their economic cooperation in clear terms of the integration theory (i.e. to define it as a free trade area, a custom union or a common market) shows the uneasiness that the two partners had about their cooperation.

Negotiations between Russia and the European Union on the Common Economic Space are also curious for our discussion because they reveal a wide difference between the parties. Both parties agreed about the need to conclude an agreement on economic cooperation to intensify their dialogue in this sphere. However, according to the Russian point of view their cooperation should have concentrated on the WTO agreements supplemented by enhanced cooperation in the spheres where parties were ready to cooperate more intensively. The underlying idea has been to cooperate in those spheres where Russia is most ready to cooperate efficiently and as an equal partner and not as an inferior partner of the European Union. This idea was manifested in numerous statements of Russian officials. For example, according to the chief negotiator, Viktor Khristenko, real economic integration will be based on investments and industrial co-operation. In particular, he stressed that

full harmonization of economic and legal systems seems to be the issue of the long-term perspective. Therefore, in the short-term we have to stress co-operation in separate prepared for the intense co-operation and integration sectors. This does not exclude harmonization of the most fundamental norms of economic activity (property rights, contract law, competition, non-discrimination, stability of tax-law, transparency etc.), however, in all other relations regulatory convergence will take place gradually under the influence of the practical needs in integration processes (Doklad V. Khristenko, 2004).

It is also noteworthy that Russia opposed the integration of the Energy Dialogue in the Common Economic Space and at some point Viktor Khristenko went so far as to call such an integration destructive for the future of the Energy Dialogue between Russia and the European Union (Doklad V. Khristenko, 2004).

The EU's idea was to insist on overall economic cooperation. That was, an extension of EU cooperation with EU candidate countries. It would be developed through projecting the EU's norms and rules and economic assistance so that Russian legal and economic system would be eventually brought in line with the European one. For example, the Commissioner for Enlargement O. Rehn said once that

the ultimate goal of the CES is to create an open and integrated market between the EU and Russia, to promote trade, investment and the competitiveness of our economic operators. However, to promote economic integration it is not enough to liberalise trade. The essential efforts must be geared towards the promotion of compatible regulatory frameworks and the proper enforcement of rules (Rehn, O., 2004).

The EU also insisted on the treatment of the Energy Dialogue as an essential part of EU-Russian economic cooperation and not as something special, requiring a separate treaty.

This contradiction in the views of the two partners was well revealed at the beginning of the roadmap on the Common Economic Space that was published together with the three roadmaps on three other spaces in May 2005. It reads that its objective is the

development of harmonised and compatible standards, regulations and conformity assessment procedures, where appropriate, including through enhanced regulatory dialogue and cooperation between responsible institutions and a reinforcement of the institutional capacities (Roadmap for the Common Economic Space, 2005).

Hence the idea is that cooperation will be wholesale, based on the full-scale legal approximation and opening of all spheres. But then the Roadmap goes on to enumerate the potential spheres of cooperation and particular activities in each of these spheres. Therefore, the Roadmap presents a clear case of synthesis of the EU's and Russian visions, which, however, makes the final goal of cooperation and the plan of actions to achieve that goal quite obscure. Moreover, the roadmap does not contain precise time-structured indicators, which drastically downgrades its value.

Thirdly, the progress of the discussion on the Common Economic Space reveals a very peculiar situation with the legal harmonisation. It is clear that any close economic cooperation is based on sufficient convergence of the regulation of the parties. Initially the PCA presupposed that Russia would copy the legislation of the European Union. Its article 55 said

The Parties recognize that an important condition for strengthening the economic links between Russia and the Community is the approximation of legislation. Russia shall endeavor to ensure that its legislation will be gradually made compatible with that of the Community. (Agreement on Partnership and Cooperation 1994).

However, this unilateral approximation was against the Russian perception of its independence. Therefore Moscow has invested much energy to change the nature of EU-Russian legal approximation and to fix the obligation of the two parties to reciprocally approximate their legislation. This is well demonstrated in the 2005 Roadmap on the Common Economic Space. Firstly, it includes the so-called new approach to legal harmonisation, which consists of the joint discussions on regulatory framework, joint determination of the areas of close cooperation and priorities in those areas and identification of procedures for possible recognition of the results of conformity assessment of both sides. Secondly, many references to the EU's terminology were deleted.⁶ Thirdly, references to the universal instruments (like IMO in case of double-hull tankers, the UN Convention of the Law of the Sea or the Convention on the Protection of the Marine Environment of the Baltic Sea Area (Helsinki Convention)) and to Russian legal acts (like the Energy strategy to 2020, the Marine Doctrine of the Russian Federation, and the Main Development Directions of the Water System Management Complex of Russia until 2010) were inserted.

On the one hand, this transformation made the concept of EU-Russian legal approximation more balanced and fair for Russia. However, on the other hand, that again led to increased obscurity because the parties do not talk about the single legal system any more but about a very abstract combination of the two legal systems. Moreover, it is dubious that the EU's 25 member states will seriously consider changing their legislation (that is reached through a difficult compromise among national capitals) only because it seriously contradicts Russian legislation.

⁶ This fact becomes particularly evident if we compare the final text with the initial proposal of the EU for this space. See European Commission (2004c).

Fourthly, the positions of the two partners are widely different in their idea about what to do with the present institutions of EU-Russian cooperation. EU representatives are very uncomfortable about the modification of the institutions or creation of new institutions only to show a more advanced stage of the relations. The 2004 Communication on Russia is a good illustration of this strategy. In particular, it says that “the current structure of cooperation and in particular the PCA is neither outdated nor exhausted. ... the Commission should pursue increased Russian engagement in particular at working level” (European Commission, 2004a). The inherent beliefs of such attitudes is that institutions have a value of themselves and that enduring institutions will at the end of the day change the quality of EU-Russian relations and transform them into a closer partnership.

Russia, on the other hand, has been keen for most of the history of EU-Russian relations on creating new original institutes that are not similar to the EU's structures or to the framework of the EU's relations with other actors and that also reflect the specificity of Moscow's external relations. The discussions on the Common economic space are a good example of this fact. Moreover, statements of Russia's diplomats and civil servants have emphasized that EU-Russian relations as well as goals of cooperation have fundamentally changed, that the quality of EU-Russian relations is different from Russia's relations with other states and, therefore, these relations require a different type of relations that are more adequate to the current state of the art and better achievement of strategic interests of the parties (Chizhov, 2005, *Otveti ofitsialnoy predstavitel'nykh organov Rossiyskoy Federatsii na voprosy zhurnalistov*, 2006).

Finally, the EU and Russia diverge on whether to build their partnership on interests or values. Conventionally the European Union is perceived as a value-oriented actor. This is manifested in numerous clauses about adherence to the common values and Russia's gradual installation of the principles of democracy, the rule of law and respect of human rights that were put on the EU's insistence into the PCA early in the 1990s. Furthermore, negotiations on the roadmaps for common spaces also witnessed EU wish to bring the four roadmaps together by a single preamble devoted to common values, which unfortunately was rejected by the Russian side.⁷

Russia is often described as a power that “alternates between cooperation on numerous practical policy issues and sometimes subtle, sometimes vehement dissent when it comes to values which underpin European policy such as democracy, human rights and freedom” (Cameron, F., Domański, J.). The idea is that Moscow insists on cooperation in some spheres that could be mutually beneficial but denies the EU's stances to transform the country along the lines offered by Brussels. The concept of (mutual) interests is the driving force of Moscow's foreign policy.

It is also good to remember that at the time of the preparation of the four roadmaps on common spaces Russia suggested that those roadmaps that were already agreed upon (for example the one for the Common Economic Space) were implemented whereas Brussels insisted on the simultaneous approval and realization of all four roadmaps. This is just another illustration of Brussels' wholesale approach and its wish to combine the benefits of economic cooperation with getting leverage over political situation in Russia. Numerous references to universal values in the roadmap for the common space of freedom security and justice that were present in the first draft were also neutralised by Russian negotiators at the preparation stage (Road Map on the Common Space of Freedom Security and Justice. Meeting doc. 392/04.). Therefore, the results of the negotiations were severely criticized by some members of the European Parliament.⁸

⁷ Interview with a Council Secretariat official. Brussels, November 28 2005.

⁸ Ibid.

Key Conceptual Differences between the Parties

To sum up the discussion on the economic cooperation between Russia and the European Union the experience of the work on the Common Economic Space demonstrates at least five conceptual differences on how to develop EU-Russian relations. *Firstly*, the European Union is used to thinking in terms of clear stages of economic cooperation while Russia insists on slower progress and hence some obscure types of cooperation that are currently described as spaces. *Secondly*, the European Union is used to projecting its full system of legislation and to the wholesale cooperation while Russian negotiators mainly insist on cooperation in very specific spheres, where Russia is ready to be an equal partner. Similarly, in the field of energy Russia insists on the preservation of favourable export conditions whereas the European Union would like to see all-rounded transformation of Russia's energy sector. *Thirdly*, the European Union insists on legal approximation on the basis of its *acquis* while Russian side defends a more balanced legal harmonization that would be based on the reciprocal movement. *Fourthly*, the European Union is keen on the preservation of the institutional structure that it is used to whereas Russia wanted to create institutions that would be specific for EU-Russian relations and characteristic of them. *Lastly*, the European Union puts values first and agrees to go for more enhanced cooperation when its partner shares the EU's values whereas Moscow defends interest-based interaction.

As the negotiations on the roadmaps and the development of the Energy Dialogue went on, the concept of cooperation evolved from the one that was initially proposed by the European Union to the one that included Russian concerns. However, that was reached at the price of inclusion of some logical contradictions in the text and of the loss of clarity as to the purpose of economic cooperation.

Moreover, most of the five lines of confrontation that are outlined above remained open. This quick analysis of the Energy Dialogue and of the preparation of the Common Economic Space demonstrates that expectations and ideas of the two partners considerably diverge. This divergence has to be tackled in the forthcoming negotiations on a new EU-Russian Agreement and will form the key lines of the negotiations. The complexity of the outlined issues, however, gives us a very vivid picture of the difficulty of negotiations that lie ahead.

Do the concepts that are on the table in Russia and the European Union provide us with a plan of how to solve the outlined conceptual difficulties? The following part of the article will address this question.

How to Reform the PCA

The launch of the expert dialogue on the future of EU-Russian relations led to the development of several alternatives on how to construct the legal basis of future EU-Russian relations both in Russia and the European Union. Most models start from the premise that there are three possibilities for the future EU-Russian relations. One is to continue on the basis of the present PCA and to implement the existing provisions. The second one is to reform the PCA so as to include some provisions that will make the treaty adequate to the present state of the relations. The third one is to prepare a completely new treaty. However, Russian specialists virtually do not consider the first option as a viable one whereas the EU's specialists give adequate attention to all ideas (supporting the EU's point of view that the PCA still presents a valid framework for EU-Russian relations).

Russian Views

Two models have competed in Russia for about a year. Both models agree that maintaining the present PCA is not an option for EU-Russian relations because it is not adequate to the present time and to the internal situation in Russia and the European Union. However, the authors of two models diverge on what to do with the present PCA.

The first model was presented even before the October 2005 summit by the committee *Russia in United Europe*. The concept brings together key Russian specialists on the European Union (economists, lawyers, political scientists but also some business people). According to this group of authors who are most often represented in publication and discussion by Nadezhda Arbatova, the present PCA should be reformed but it is not the time to prepare a completely new EU-Russian treaty. This is mainly due to the fact that the European Union is not ready to experiments because of the current difficulties with the Constitutional Treaty and because of the enlargement consequences. Moreover, Russia is too contestable a partner for Brussels at present to fundamentally transform the EU-Russian relations. According to the authors of this model ratification of a completely new treaty is not guaranteed because the demands of 25 member states on EU-Russian relations are different. In addition they fear the legal vacuum that may appear in the event of a long ratification. Finally the authors of this model are worried about the preservation of the positive experience of the PCA, they in particular cite the so-called Simoutenkov case of the European Court of Justice that guarantees some basic rights to Russian nationals permanently employed in the European Union (Arbatova, 2006).

Instead the authors propose to reform the present PCA along the lines of the EU's association agreement with no obligation to regard Russia as a potential candidate for membership in the European Union. The suggested name for a new treaty is 'the treaty of advanced partnership establishing an association'. The four common spaces (economic, on external security, on freedom, security and justice, and on research and education, including the cultural aspects) should form the basis of the new agreement. The reformed PCA, according to the proponents of this point of view, should presuppose the eventual establishment of the four freedoms (of movement of goods, services, capital, and labour) between Russia and the European Union. Legal harmonization to the degree that is necessary for the installation of the four freedoms should be introduced. The parties, according to the authors of this model, should also cooperate in external affairs and education and science (Arbatova, 2006).

In my view the outlined changes to the PCA present a fundamental transformation of its character and therefore (in contrast to what the authors of this model believe) it will be impossible to avoid a new round of ratification in both Russia and the European Union and its member-states if this model is taken as the basis for the transformation. But the idea to preserve the existent PCA signifies the continuity and qualitative development of the existent relations, policies and institutions. Moreover, the model is also developed through the prism of the EU's visions of the relations with third countries and therefore takes the harsh EU line in the conceptual differences that I outlined earlier. A Russian commentator once said that the proponents of this model want to lock Moscow in the corridor leading to the European Union and throw the keys out of the window to deprive Moscow of any option but to reform its political and economic system along the lines of the EU's legislation.

The second project was presented after the 2005 autumn summit by a much smaller group of authors who work in the *Russia in Global Affairs* journal. The model is popularized mainly by Timofei Bordachev. Their vision is much less pro-European. They argue for the fundamental change of the legal basis of EU-Russian relations. The idea is that Moscow should not just follow the course of actions and types of cooperation that are proposed by Brussels but it should develop a new quality of the relations together with Brussels based on the particular

status of Russia in the international arena. In the words of the proponents of this model, Moscow should formalize the multi-vector diplomacy of Moscow (Bordachev, 2006).

In particular the authors argue for the substitution of the current PCA with a new treaty that will not be like other treaties of the European Union. They argue for a non-binding declaration on EU-Russian relations that would include basic principles of EU-Russian relations. It would touch upon cooperation in external security, in justice and home affairs, in economy and in free movement of people across the borders. In sum, all the topics that are currently raised in the roadmaps on four common spaces would be there. This declaration would also give a signal to the partners in Brussels that Russia is not going to unilaterally harmonise its legislation with the EU's one but will rather follow its own course of reforms or would agree on reciprocal movement in some legislation and policies. Finally, the authors of this project believe that the declaration would put an end to the dominant role of the technocratic European Commission in designing the agenda for EU-Russian relations.

The declaration should then be supplemented by more detailed and binding agreements in those sectors that are of interest to Russian players (like the space or energy cooperation). Hence the emphasis is put on the idea of the integration *à la carte*, on sectoral cooperation, which is much easier in terms of management and the preservation of the balance of interest of the two parties. This method should also simplify the process of the ratification of new agreements in all parties because both the EU (and its member-states) and Russia will see clear advantages in their cooperation and will not stall the process of cooperation that is mutually beneficial.

This model was once compared to the road traffic situation where all EU members and actors follow the traffic lights and driving rules (established by Brussels) whereas Russia wants to drive using special signals and police escort. In fact in all five conceptual issues the project sidelines with the Russian line of arguments and even brings some issues to the extreme.

The difference between these two models is stark, indeed. The first one is 100% pro-EU (may be even more pro-European than Brussels would consider realistic) while the second one reflects the vision of the majority of Russian specialists and foreign affairs officials. The debates between two models demonstrate precisely the difference between the EU's vision of the relations as being well-rounded and wholesale and the traditional Russian attitude, targeted at the preservation of maximum autonomy and at sectoral cooperation. The debates are made more acute by the fact that most of the Russian business people are currently interested in sectoral integration. The most interested parties are energy companies, metal exporters and agriculture producers (Pleaines, 2005). Most of the other Russian business is interested in weakening EU competitors and hence they try to erect barriers or at least not to destroy the existent hindrances to EU investments.

Furthermore, the difference between the two models is in whether Russia should adopt the course that is offered by the European Union and follow its idea of relations with the external world or whether the partners should design something specific for their particular relations. The advantage of the first way is clarity whereas the second one, if successful, would be the most adequate to the present conditions and specificity of the two partners. The issue of legal approximation is closely linked to it. If Moscow follows the model, suggested by the European Union, then it should harmonise its legislation with that of the EU. If, however, it believes in its own way, then the partners can only agree to reciprocally approximate their regulations.

Thirdly, the two models are different in how they treat the EU's assistance with the first one based on the idea of using the future EU's partnership and neighbourhood instrument and the second one neglecting the EU's assistance at all. In fact the difference in the attitude

towards the EU's assistance is just a continuation of either the course on legal approximation to the EU's norms or maintenance of the independence of regulation with possible rapprochement in some spheres of cooperation.

Fourthly, the models are different in whether they propose to maintain the key structures and institutions of EU-Russian relations or to drastically change them to do away with the traditional Brussels technocratic approach, where the European Commission and experts dominate.

Finally, there is a stark difference in how the two models view the values-interest debates. The first Russian project takes it for granted that Russia shares the EU's values. The second one does not address this issue at all.

What is more fundamental is the fact that the two models are two different poles of EU-Russian relations and they present extreme views on these relations with the first one, promoted by a narrow circle of experts on the EU, and the second one being much more popular among Russian actors. In a way none of the two models can be followed and the combination of the two should be presented. However, the problem is that none of the groups of authors has the idea of how to combine the peculiar character of EU-Russian relations with the idea of the independence of Russian regulation and the need to design a common course of actions with the EU unilaterally designing this course of actions. Moreover, the debates between the two visions is mostly the debate about what form to choose but not about how to solve the five conceptual contradictions that present cooperation revealed in the economic part of the relations.

It is worth mentioning that the Kremlin has for quite some time considered the possibility of commissioning a draft EU-Russian treaty to the expert community but until now the Presidential Administration has not announced the call. The reason behind is possibly that the President and his Administration do not want to constrain themselves by a definite model and want to have a free hand for the moment. At the same time the Kremlin has prepared guidelines for future negotiations that at the moment are classified. All that is known is that it sticks to the idea of a binding agreement and reflects Russia's particular vision and its specificity in the world arena.

EU Views

At least two Brussels' think-tanks have by now become seriously involved in the debates on the future legal basis of EU-Russian relations. Although none of them denies the possibility of the continuation of the PCA (unlike Russian participants of the discussion) they mainly concentrate on either its reform or substitution.

The first think-tank that recently came to discuss the 2007 problem in EU-Russian relations is the newly formed *EURussia Centre*. They have not promoted their own vision on how to solve the 2007 problem but they published a survey of opinions of different EU stakeholders on how to reform the PCA (The EU-Russia Centre, 2006). It appears that the interested parties mainly focus their attention on two aspects.

The first one is the issue of internal coordination and the absence of the single EU position on Russia. In particular, nearly 70% of the respondents feel that EU member states put national interests first in their dealings with Russia rather than supporting the EU's single position. 58% also believe that EU institutions have made little headway in their efforts to achieve a common position on Russia. The behaviour of member states that undermines the single position attracted more attention of the stakeholders than actions of EU institutions.

This is consistent with the opinions of many Brussels officials who believe that the key change in the EU-Russian treaty should not be about the substance of cooperation but rather about the institutions and procedures and about the division of responsibilities between EU institutions and member states.⁹ They also believe that this is an internal EU issue, which should be decided behind close doors. It is worth mentioning, however, that Moscow will try to use this situation to its advantage and to drive a wedge between member-states and Brussels institutions.

The second issue of concern to the respondents is the political part of the treaty. In particular, most of them believe that the EU is not doing enough to promote democracy and political reforms in Russia and 81% would like to see the EU seek greater leverage in the renewed agreement to address democracy, civil liberties, judicial interdependence and the state of the rule of law in Russia. It is also significant that to 49% of those surveyed EU institutions do not respond robustly and quickly to Russian political development.

To sum up, most of the respondents consider the continuation of the current practice of wholesale integration and unilateral legal approximation appropriate and do not consider the transfer to sectoral integration. Moreover, they insist on tighter binding of political transformation of Russia and economic integration between Brussels and Moscow on the basis of the rules emanating from Brussels. It is proper to cite here an EU official who once said to the author of this paper that Morocco is even more dependent on the European Union in its external trade but does not ask the EU to participate in its internal decision-making or to work for the establishment of the common regime, it just takes the EU's leading role in designing the legislation and legal norms for granted.¹⁰ This orientation on wholesale economic cooperation (although in milder terms) can also be identified in the report presented by the European Round Table before the EU-Russian summit in May 2006 (European Round Table, 2006). Finally EU-Russian institutions are taken as permanently existing and not needing a change.

The second think-tank is the *Centre for European Policy Studies* (CEPS). In May 2006 it published a policy brief that summarizes possible options for the future of EU-Russian relations (Emerson et al, 2006). The authors of the brief come up with the following models of EU-Russian relations:

1. retire the PCA without replacement (This option is examined as highly improbable but the one that cannot be completely excluded.)
2. extend the present PCA (This scenario foresees the conclusion of multiple sectoral agreements (like negotiations on the WTO, the Energy Charter Treaty or the four roadmaps) alongside with the maintenance of the hard core in the form of the existent PCA.
3. extend the status quo with the Political Declaration on Strategic Partnership instead of a binding treaty (This scenario, according to the authors can be implemented when the partners are ready to come to a new stage in their relations. It will be a transit phase to a qualitatively new treaty in EU-Russian relations.)
4. replace the PCA with a short treaty on strategic partnership (This scenario is different from the previous one in that it takes a legally binding document as the centerpiece of EU-Russian relations. However, the CEPS experts fear that it might just fix the current state of play and be nothing but a cosmetic diplomacy that only adds some prestige to Russia with no real change in the quality of the relations. It can also face difficulties at the time of the ratification in the national parliaments of EU member-states.)
5. replace the PCA with a comprehensive treaty on strategic partnership (This scenario is the closest one to the one promoted by the *Russia in United Europe*

⁹ Interviews with Brussels officials conducted in November 2005.

¹⁰ An interview with an official from DG TRADE in November 2005.

committee. But this long version, according to the CEPS experts, would involve protracted negotiations and will again lead to the painful process of the ratification, according to the CEPS expert.)

6. negotiate a Treaty of Strategic Union (This is a global treaty that would signify an all-European cooperation, a reconciliation that is similar to the French-German reconciliation of the 1950-1960s and “a determination to replace old enmities with a totally new paradigm of common purpose” (Emerson et al, 2006). It would give the status of equal partners to the European Union and Russia.)

According to the CEPS analysts the relations will be developed gradually and in the short-term perspective the parties should bet on the preservation of the status quo. However, they should then develop their relations taking into consideration the third scenario (based on the Political Declaration on Strategic Partnership and sectoral agreements) and only in the long-term can they come to the Treaty of Strategic Union.

Curiously the CEPS analysts sideline with the idea of the sectoral cooperation promoted by the *Russia in Global Affairs* journal as the only viable one at present and in the near future. They bluntly say that “the model of the comprehensive treaty, covering all sectors of mutual interest in legally binding form, ratified by the parliaments of all EU member states, is ill-adapted to the needs of the EU-Russian relationship” (Emerson et al, 2006). At the same time they do not deny the possibility of a binding treaty between equal partners in the long-term perspective, which is in a way a hybrid of the two visions that are debated in Russia but at present is nothing but a wishful thinking, primarily because there is no interest in it in Brussels and there is no flesh in this idea.

Thus, in essence Brussels mainly promote its present point of view. Its think-tanks insist on the wholesale cooperation on the basis of the EU’s rules with Russia’s unilateral approximation to the laws designed in Brussels and preservation of the present EU-Russian institutions at least in the short and medium term perspective. The fact that this will be a legally binding agreement is constantly stressed by Brussels. The discussion in Brussels, therefore, mainly concentrates on internal institutional coordination and decision-making procedures and on the importance of the value component. It does not seriously tackle the question of how to solve conceptual problems and contradictions that hamper present EU-Russian cooperation.

The recent (July 2006) Commission draft negotiating directive (European Commission, 2006) submitted to the Council of Ministers reflects precisely this idea. According to the Commission communication, it asks for the mandate to design a new “updated and more ambitious framework for the EU-Russian relationship” (European Commission, 2006). According to the same document, the future agreement is supposed to cover “the whole range of EU-Russia cooperation, with a particular focus on progressive deepening and development of trade relations and fair and open development of the energy relationship between the EU and Russia” (European Commission, 2006). Thus we can see not only the orientation on wholesale cooperation but also the emphasis on progressive opening of Russian energy sector to its partners, which reminds us of a contradiction in the energy cooperation that I depicted earlier. Finally, the importance of common values as the basis for the cooperation is stressed in the Commission communication. In sum, the die is cast in Brussels and, despite some internal discussion, it is cast along the lines of the traditional Brussels position.

In fact, the preservation of this traditional orientation reflects a similar crisis of conceptual thinking as we witnessed in Russia and the similar inability to cope with the five conceptual difficulties that lie in the heart of all the problems of EU-Russian economic relations. In the case of Moscow that was the inability to strike a middle course between the unilateral orientation on the EU’s norms and the wish of independence, to leave behind the question of

form and think about how to integrate two different options. In the case of Brussels it is the sincere inability to design anything alternative to the course that has been previously suggested to acceding countries and neighbours of the EU, to the course that is unilateral and in a way humiliating EU partners unless they are offered specific benefits in return for a sit at the EU's table in the future. It is also a deep desire to do away with structural problems of EU foreign policy conduct.

What scenarios in the Future?

What awaits us ahead? As I demonstrated above the conceptual contradiction between Russia and the EU are multiple. They are about the goal of cooperation in the economic sphere, about the type of cooperation (wholesale or sectoral), about the division of roles (whether it will be a unilateral action or a joint search for the common basis), about the fate of the existent institutions and the design of the new ones, and last but not least about the combination of values and interests. The visions presented both in Moscow and in Brussels are a clear illustration of the crisis of strategic vision in both partners and of the inability to come up with the viable and mutually acceptable models.

In my view present scenarios of the development of EU-Russian relations can be divided into short-term scenarios and long-term ones. This is based on the assumption that it will take some time to negotiate a new EU-Russian agreement. The negotiations will not start before 2007 because the Commission has to receive a mandate from the Council and this will only happen by the end of 2006. There is no clear consensus of the parties in what should be in the agreement (only specific sectors or some basic common provisions¹¹) but the parties do not trust each other and therefore the choice will be made for the legally binding agreement to provide tangible guarantees to both public and private parties involved in EU-Russian relations. This will lead to the need to ratify the document. At the same time the agreement will be a mixed agreement, i.e. involving the competences of both the European Union and its member-states. Thus it will require the ratification of all EU member-states, which is indeed a long and cumbersome procedure and will take up to two years. Moreover, the well-known 2008 problem in Russia (i.e. the presidential elections) will interfere the process. All these facts bring me to the conclusion that the parties will not start living on the basis of a new agreement until at least 2009-2010. Therefore the short-term perspective is the one between now and 2010 and the long-term perspective is after 2010.

Short-Term Perspectives

Two scenarios are possible in the short-term. One is to continue on the basis of the present vague provisions of the PCA and to update it with some clauses following Russia's accession to the WTO and other changes in the multilateral framework. This scenario will not lead to dramatic changes in EU-Russian relations but at the same time will preserve the sense of stability and predictability that will allow for the growth of investments and enlargement of private contacts.

The second scenario is an extension of the first one and presupposes deeper cooperation on the basis of the four roadmaps for EU-Russian common spaces that were adopted in 2005. Although these roadmaps are not binding and they do not contain a timetable of actions they present a certain action plan that is of interest to the parties and that can be realized in the present legal framework of EU-Russian relations. Moreover, the positive experience of this realization can feed into the discussion on the development of the new agreement.

¹¹ Although some EU and Russian officials reveal that the mandate that the European Commission suggested and the draft paper that is developed in the Kremlin are quite similar.

Long-Term Perspectives

The long-term scenarios are much more obscure. This obscurity is caused by multiple factors. One is the wide conceptual difference between the parties that I exposed and which none of the present drafts addresses. Another one is the difference in their bureaucratic machinery, where Russia is used to pushing the decision-making upwards whereas the EU's mode of work is to decide as much as possible at the lowest possible level. This prevents the parties from working out an efficient institutional structure of cooperation. Furthermore, there is much hesitance about the so called 2008 Russia's problem of when the new presidential elections are to be held. All these factors contribute to the uncertainty of the way ahead.

However, there are broadly two possible scenarios in the long-term. One is based on the idea of a small agreement that fixes basic principles of economic and political cooperation and the obligations of the two parties. As I stated above this agreement shall be binding. The agreement can be then supplemented by more detailed agreements on cooperation in specific fields (like energy, space, science and technology and so on). This sort of agreement is the most plausible in my view and would satisfy both the EU and Russia.

The small core agreement would contain some specific articles on the goal of economic cooperation, on the degree and type of legal approximation as well as on institutional provisions of cooperation. It should also solve the interest / value debates or at least find some middle ground here. A possible option can be to include a reference to universal values without typical EU provisions on political conditionality. The exact balance between the basic agreement and the sectoral agreements remains open and will definitely require long discussions between the parties. The model of the EU's relations with Switzerland can provide a reference in this case because of its famous guillotine clause and a very tricky balance of the sectors of deep cooperation.

Another option is the one, which is promoted in Russia by the committee *Russia in United Europe* and by some EU experts and analysts. This is the option of a very detailed agreement that embraces all spheres of cooperation, and leads to a very specific close integration between Russia and the European Union with Russia's unilateral approximation and binding obligations in all spheres. In my view this option remains nothing but a wishful thinking because the way the EU and Russia view their cooperation diverge a lot and it would take too much time to agree on all spheres of potential EU-Russian cooperation. Moreover, it would make the legal basis of EU-Russian cooperation a hostage to all sorts of petty details on which many EU member states differ.

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Does the broadening of the EU detain its competitiveness in the world market?

Urmas Varblane¹²
University of Tartu

Abstract

The article is trying to explain the impact of enlargement on the competitiveness of European Union on the world market and on the competitiveness of EU-15 against the new member states. The paper argues that the impact of EU enlargement on the competitiveness on the world market is positive due to providing growing market, supply of skilled labour and increasing efficiency through growing competition on the single internal market. The impact of enlargement on the competitiveness of EU-15 is country group dependant. The Nordic countries are better prepared themselves to compete on the liberalised EU internal market and invested heavily into the future growth (education, research and diffusion of new technologies), which creates flexibility and ability to adjust. The new EU member states are used by Nordic countries mainly as the complementary factor, which helps to compete on the world market. Reallocation of labour intensive industries into the new member states is pushing the domestic industry and service sector in Nordic countries to increase the value added content. Accumulated investments into human capital could facilitate this process in the Nordic countries. Weakest is the position of southern periphery countries of EU, which will face the entry of the new member states as direct competitors and substitution effect prevails. Substitution means that the new member states are offering goods and services, which are with the relatively similar factor intensities than they could provide. Southern EU countries have much lower ability to adjust as their human capital is weaker and they have invested less than Nordic countries into the future growth. The competition from the new EU member states will force Southern periphery and also continental European countries to invest into future growth and support the competitiveness of EU on the world market.

Keywords: competitiveness, enlargement, European Union, relocation

¹² Urmas Varblane, Professor of International Business, Faculty of Economics and Business Administration, University of Tartu, e-mail varblane@mtk.ut.ee

Introduction

The recent economic and political disputes in the Europe have been often full of criticism on the last EU enlargement and the sentiment is very strong to explain the current problems of the core EU member states as the result of including many new and poor countries into EU. The following article is trying to explain the role of new member states in two frameworks. First is about the competitiveness of European Union on the world market after the enlargement. Second is the competitiveness of EU-15 against the new member's states. This kind of twofold approach allows explaining, why on the level of ordinary citizens of European old member states the enlargement has been seen as the major threat to their security and on the other hand why the politicians and economists generally supporting the enlargement as the major rescue factor for European competitiveness on the world market.

The structure of the paper is following. First section is dealing with the theoretical bases of the concept of competitiveness. Second part is dealing with the development of European competitiveness in the world economy and particularly in comparison with the US. Third section is dealing with the general integration effects associated with the regional integration. Following part covers the trade effects and analysis the new member states as a new and rapidly expanding market. Next section is about the new member states as the investment target. The role of the human capital of the new member states as the facilitator of the European competitiveness is covered in the next section. Last section is about the enlargement as the process of encouraging the liberalization inside the European Union on the example of the tax policy.

Theoretical concepts of the competitiveness

Competitiveness is a concept which may be defined in different levels of depth. In the broader sense competitiveness could be defined on three levels as the:

- 1) ability to survive - the lowest level of competitiveness, refers to the ability to adapt passively to the competitive environment without significantly changing or developing itself;
- 2) ability to develop - the medium level of competitiveness, refers to the ability to respond actively to the changes in competitive environment and thereby improve its own qualities and make its activities more efficient;
- 3) superiority- the highest level of competitiveness, refers to the ability to influence competitive environment through more efficient operation, quicker development or better qualities than competitors. (See Reiljan et al, 2000)

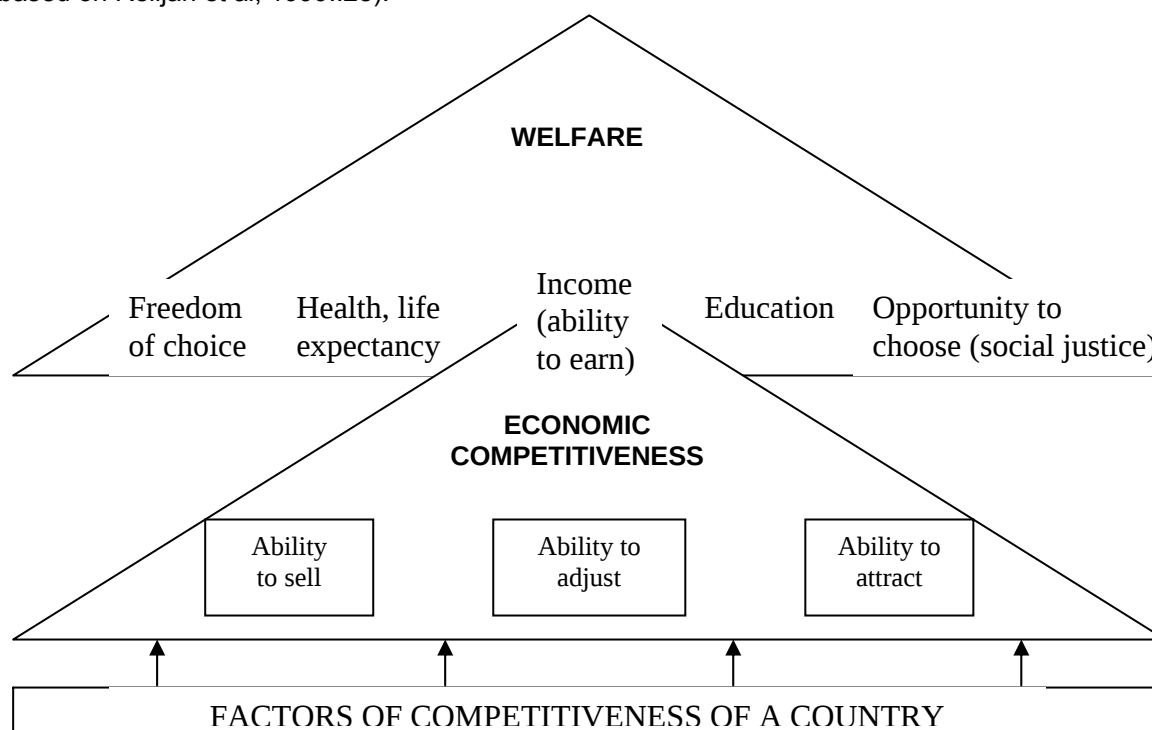
In lower degree of abstraction the concept of competitiveness could be applied on different levels of the focus as national, regional, international or using different classification on the macro, meso or micro level. The competitiveness of the country or sector could be revealed in comparison and therefore it is a relative term. There exists a huge literature about the competitiveness and also exists a group of economists, who declare that the concept competitiveness has nothing to do with economics and this is purely political term used by politicians in the various contexts. For example P.Krugman has declared that productivity is the metaphor and the real essence of competitiveness is reflected in the productivity (Krugman 1996:18). But many economists (particularly in Europe) still do not agree with this kind of simplification about the competitiveness. They have stressed the idea, that competitiveness of a country should be described not only by the economic growth but also the welfare of the people (Aiginger 1996:125, Fagerberg 1996:48). It means that also the distribution of created wealth plays important role as well as the opportunities of population to get good education, to live healthy life.

In the following figure is presented the whole hierarchical system of socio-economic competitiveness of a nation. Economic competitiveness is located as the basement of the

competitiveness of a country. It consists of three components - ability to sell, ability to adjust and ability to attract, which all together create the ability of the country to earn, which is located on the higher level of the hierarchy of competitiveness (see Figure 1). Ability to sell indicates the nation's ability to sell its products and services on the world market, the ability to attract indicates the ability of the nation to create locational advantages, which allow attracting production factors. Ability to adjust refers to the nation's ability to adjust quickly to the changes on market and to the opportunities that can be provided the changes in the global environment. The synthetic economic competitiveness indicator is nations ability to earn, which may be measured by the GDP per capita

As the figure 1 demonstrates, economic competitiveness is only one part in socio-economic competitiveness of a country. Freedom of choice as well as ability to choose (meaning that besides rights an individual should also have opportunities created by the state), health and education conditions is equally important components besides economic competitiveness.

Figure 1 Hierarchical system of the formation of socio-economic competitiveness of a country.
(based on Reiljan et al, 1999:28).



As the figure states, the ultimate goal is the ability of the nation to create wealth. The ability to create wealth is more important than the wealth itself, as it guarantees the substitution in case the wealth is lost. This is extremely important in the situations of negative changes in the global environment. In general the welfare of the nation and the level of accomplishing this goal is the best measure of competitiveness relative to other countries. This approach allows more broadly understand the complexity of the competitiveness of the nation and avoid the too narrow approach of competitiveness often followed, where GDP per capita is used as the major indicator. Provided more complex system of competitiveness also helps to understand the differences between the European Union and US covered in the following section.

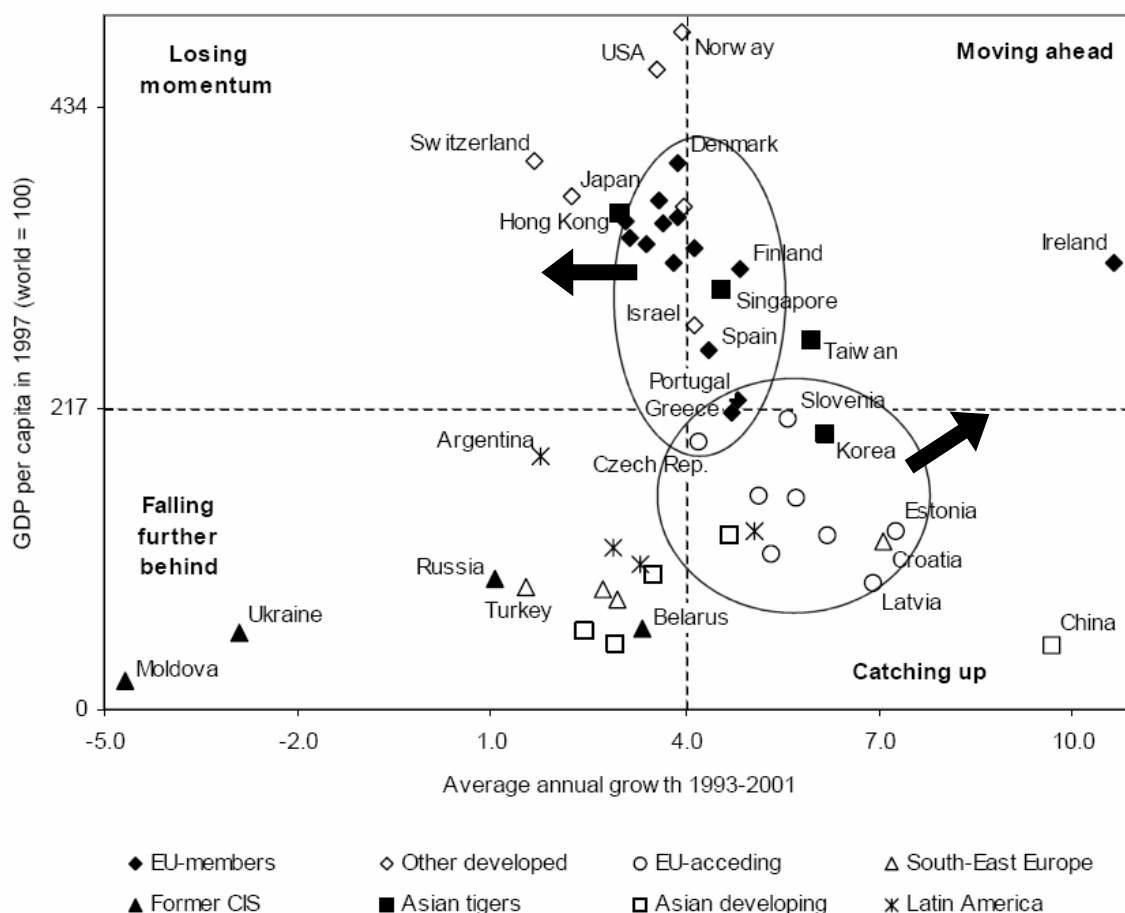
Fagerberg (2004) has suggested another approach to the identification of the economic competitiveness of the nation. The starting point in his classification is the idea derived from J.Shumpeter that the core of the competition is not price but technological competition. From this Fagerberg derived four aspects of competitiveness: technological, capacity, cost and

demand competitiveness. Technological competitiveness refers to the ability to compete successfully in markets for new goods and services and is closely related to the innovativeness of a country. Capacity competitiveness is about the ability to develop human capital, ICT infrastructure, diffusion and social and institutional aspects of the nation. The price or cost competitiveness is the classical competition described in the textbooks and reflected for example in the unit labour costs. By the demand competitiveness was understood the relationship between a country production or trade structure and the composition of world demand.

Dynamics of the EU competitiveness in the world economy

In the beginning we are trying to position EU and its new member states presenting results of Fagerberg et al., 2004. They used simple approach and compared the average productivity or income over the period (measured as GDP per capita in PPPs in 1997) with the annual average growth over the period (1993-2001). Following figure 2 is giving the position of 49 countries. As the result of used indicators four quadrants emerged. Upper left quadrant consists of countries with a high level GDP per capita but relatively slow growth - "losing momentum" (Japan, Switzerland). Upper left quadrant is moving ahead type of countries that continue to grow fast despite a high level of GDP per capita (Ireland, Finland, Singapore and Taiwan). Majority of EU-15 countries are positioned on the borderline between "losing momentum" and "moving ahead", indicating a growth performance close to the average of the sample. On the figure is added an arrow to left indicating the general direction of EU-15, keeping the same relative income and reducing the speed of growth during the recent period 2001-2004.

Figure 2 Overall Competitiveness (GDP per capita, current US dollars in PPP) Source: Fagerberg et al, 2004 with additions from author.



Lower right quadrant are “catching up” countries including all new EU member states, China, Korea, Malaysia. On the figure 2 is arrow indicating the growth of income and speed of growth as well during the recent period 2001-2004. Lower left quadrant is the worst case, where countries had low level of income and growing slowly (Moldova, Ukraine). The results of the figure 2 are indicating that the new member states are located rather closely in the catching up area.

The question about the impact of the enlargement on the competitiveness of the EU could be divided into two parts. First issue is how the enlargement will influence the external competitiveness of EU against the main competitors on the world market. Second part of the question is how the enlargement affects the internal competitiveness of old EU-15 in the new European Union as a regional trading block. The second aspect of the impact of enlargement has been a major problem behind the recent hindrances on the deepening of the integration inside the EU by voting against the EU constitution in France and Netherlands.

In the beginning will be analysed the dynamics of the competitiveness of European Union against the United States as the major competitor on the world market based on the different indicators of productivity. In the following Table 1 are represented results about the GDP per capita, GDP per employee and GDP per hour worked in US and EU-15. The catching up process of Europe was rapid during the post Second World War period, and continued also during 1980s up to mid 1990s (seen in Table 1).

Table 1 European Union and United States compared by the GDP per capita, employee and hour in 1980-2002 (Aiginger, 2005: 110).

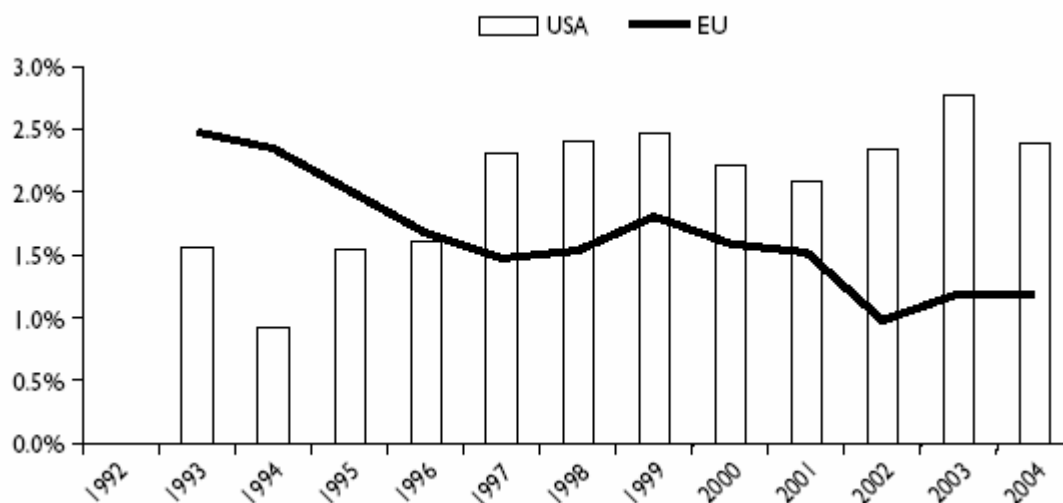
	GDP per capita			GDP per employee			GDP per hour		
	EU-15	US	US/EU-15	EU-15	US	US/EU-15	EU-15	US	US/EU-15
	thousand euros		times	thousand euros		times	Euros		times
1980	16.30	22.31	1.37	39.84	51.16	1.28	23.00	27.93	1.21
1990	20.08	27.88	1.39	47.43	58.66	1.24	28.82	32.25	1.12
1995	21.30	29.81	1.40	52.52	62.79	1.20	32.53	34.13	1.05
2002	24.43	34.08	1.40	56.26	72.94	1.30	35.52	38.83	1.09

But afterwards the convergence process was replaced with the stagnation and during last five years divergence of income levels started to emerge. GDP per capita has been in US 40 per cent higher than in EU and convergence has not been seen. Between 1991 and 2002 GDP growth in EU-15 was 1 percentage point less per year than in the United States, labour productivity expanded by 1.6 per cent compared to 2 per cent in the United States and employment increased by 0.6 per cent in Western Europe compared with 1.1 per cent in the United States. In total it means that over this period the cumulative growth of GDP was 26.5 per cent in EU-15 and 40.7 per cent for the United States. The results from the Table 1 explain the phenomena of Europe during last decades, when the reduction of worked hours was covered by the growth of hourly productivity leaving the relative GDP per capita compared with US roughly unchanged. Blanchard (2004) has given detailed information of comparison between US and France. In the United States, over the period 1970 to 2000, GDP per hour increased by 38%, hours worked per person by 26% which produced GDP growth per person by 64%. In France, over the same period, GDP per hour increased by 83%, but hours per person decreased by 23% and consequently the GDP per capita only increased by 60%. These numbers indicated that in France the productivity of work was basically the same as in US, but people are working less. The growth of hourly labour productivity was in France even much higher than in US (Blanchard, 2004:5).

The analysis by Blanchard, 2004 indicated that the most of the decrease in hours worked per person has come from the decrease in hours worked per worker, rather than from the increases in unemployment or decreases in participation rates. In France for the period 1970 to 2000 hours per worker decreased by 23%, from 1962 hours per year in 1970 to 1550 hours per year in 2000. The unemployment rate increased by 7 percentage points, from 2% in 1970 to 9% in 2000. And the participation rate increased by 7%, going from 0.42 in 1970 to 0.45 in 2000. In France the full time wage earners worked an average of 45.9 hours in 1970 and only 39.5 hours in 1999 and down to 35 in 2002. The same trend is actually happening also in Ireland, where average hours worked decreased from 2140 in 1970 to 1670 in 2000. (See Blanchard, 2004)

Therefore it is a general trend in Europe and several economists have proved that this is mainly voluntarily made decision of workers and not the result of the increasing tax distortions. There exists different choice between income and leisure. But the situation since late 1990s is rapidly deteriorating for EU. The period 1995-2004 has been remarkable for EU-15 in losing quickly the speed of productivity growth per worked hour. In the following figure 3 is shown that the gap between US and EU-15 emerged in 1997 and has deepened in 2002-2004.

Figure 3 Labour productivity per hour (Real GDP divided by total hours worked; annual growth, moving average (centered over three years) (Lenain, 2005:16).



The typical explanation offered by economists, why Europe is lagging behind US in productivity is high welfare costs, rigid labour market rules and higher environmental standards than in US (Aiginger, 2004, 2005). Applying the competitiveness model described in the theoretical part of this article above on the figure 1 means that EU-15 has been trading off ability to earn against welfare objectives. But in Aiginger, 2005 is presented an interesting analysis, which proves that the best performing EU-15 countries over the last 15 years in terms of economic performance have been Nordic countries (Denmark, Finland, Sweden) with their excellent welfare systems and a highest environmental awareness in the world. They all passed also structural and cyclical crises in the 1980s and 1990s, but last two decades they performed much better than the central EU countries and they are catching up the United States. Aiginger called them as the top-3 in EU. So it means there should be other explanations for this development and this could be the investments into future growth, which is understood as investments into education, ICT, technologies. Aiginger(2005) shows convincingly that the strongest and increasing difference between the United States and EU and also between the Nordic countries and central European countries is the dynamics of investment into future growth, such as in education, research and diffusion of new technologies (ICT and biotechnology). He used 16 indicators to measure the investments of countries in these variables and got an astonishing result that by the end of the 1990s US was leading in 14 of the 16 indicators. Inside EU as well the Nordic countries were leading in all these aspects against the central EU countries. On the other hand are three big economies – France, Germany and Italy, called by Aiginger as Big-3, which have not succeeded in structural reforms, trying to be protectionists (e.g. actions of France against service freedom directive) and do not invest as much to the future growth as Nordic countries. Finally there is a group of southern periphery countries (Portugal, Greece, Spain), which are even weaker in investing into future growth.

Coming back to beginning of this subsection the impact of enlargement on the competitiveness of the EU-15 should be distinguished by the groups of countries. The top-3 Nordic countries have been prepared themselves to compete on the liberalised EU internal market and also world market and straightforwardly invested into the future growth. The new member states are used by Nordic countries mainly as the complementary factor, which helps to compete. Complementary means that the new member states are offering goods and services, which are produced with the different factor intensities than they could provide. Reallocation of labour intensive and also material intensive industries into new member states is pushing the domestic industry and service sector to climb up the value added ladder. Here the previous heavy investments into human capital and future growth areas help

to be flexible and ability to adjust is the best among the Nordic countries. Therefore the threat of enlargement is clearly milder in Nordic countries than in Big 3. Weakest is the position of southern periphery countries of EU, which will face the entry of the new member states as direct competitors and substitution effect prevails. Substitution means that the new member states are offering goods and services, which are with the relatively similar factor intensities than they could provide. They have much lower ability to adjust as their human capital is weaker and they have invested significantly less than Nordic countries into the future growth.

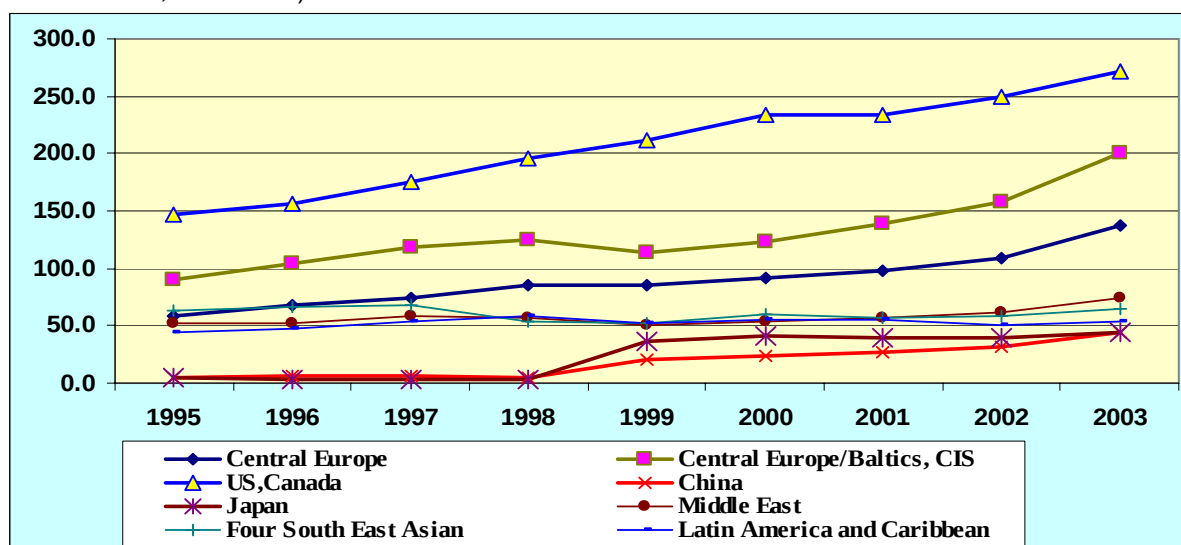
The trade effects of the enlargement – the new member states as a new and rapidly expanding market

The enlargement of the EU as the method of further regional integration is associated with several integration effects. The traditional approach is to outline allocation, accumulation and location effects (Baldwin, Venables, 1995). The allocation effect is about the reallocation of resources between participating countries and the major instrument is free trade, which is causing the reallocation of resources. The accumulation effect is the result of changes in the rates of return on investment in the member countries of regional blocks and will be expressed in the form of investment creation and diversion. Finally the location effects are linked with the regional disparities and spatial agglomeration of production.

The strength of the integration effects depend on the degree of integration. In case of EU enlargement the new members entered into the very high level of economic integration in the form economic union. Therefore standard effects of regional integration are combined with specific effects of EU enlargement as the four freedoms of the Single Market (free movement of goods, services, capital and labour) means that factor movement is also liberalised. Often in literature it is called as the single market effects (Breuss, 2001).

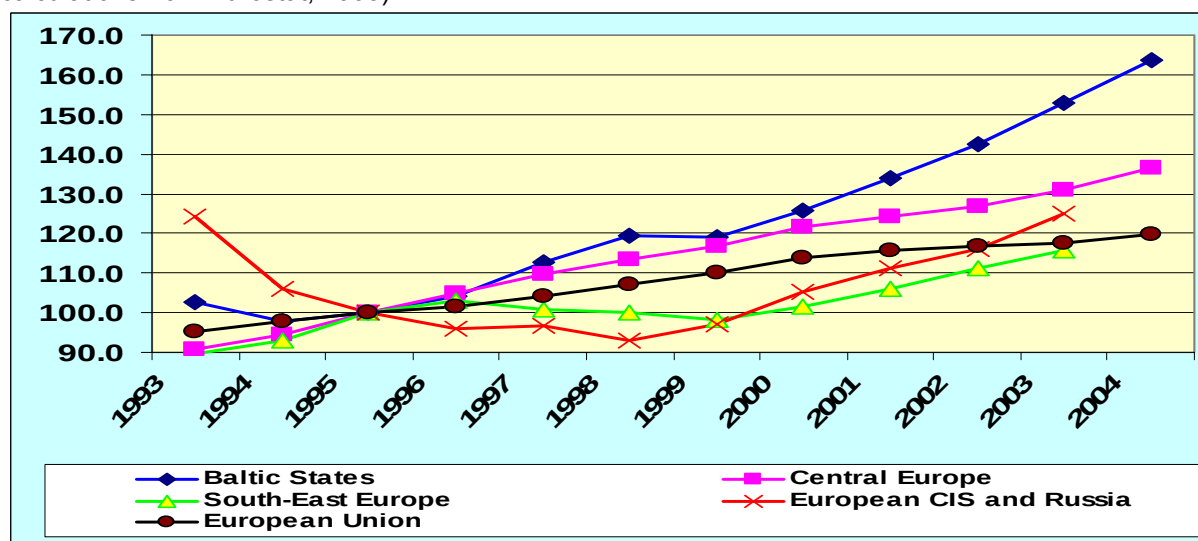
The enlargement has first of all linked with the allocation effects in the form of trade creation. The trade effects of the enlargement actually started to emerge long before the new members joined EU. Since signing the association agreements between EU and accession countries trade was gradually liberalised and this caused tremendous trade growth. This has been beneficial to the both sides, but until the end of 1990s the trade surplus of EU-15 was around 20 billion euros per year. Since 2000 the trade between EU-15 and future new members started to balance. Following figure 4 is presenting the data about the growth of EU exports to the different regions and it shows the very rapid growth of exports to the Central Europe, Baltic's and CIS.

Figure 4 Dynamics of the EU-15 exports to the major trading partners 1995-2003 (annual exports in billion USD, WTO data).



It is only matter of time, when the export to these countries will surpass export to the US and Canada. The export of EU to Poland is as big as the EU export to China. This trade growth has supported to create and keep jobs in EU-15. The potential of the future trade growth is also very promising, which may be evaluated looking on the GDP growth speed gap between the EU-15 and new member states presented on the following figure 5. This figure presents data about the cumulative real GDP growth with the 1995 being the base year. On the figure 5 the central European group of new member states and especially Baltic countries clearly outperformed the EU 15 cumulative growth. Within the period 1995 till 2004 the total real GDP growth was 19.9 % in EU-15 against the 63.4 % in Baltic and 36.6 % in the Central European countries. This is an indicator of the rapid growth of purchasing power in the region of new member states which is fuelling also the export sectors in EU-15 and therefore also producing employment in the whole Europe.

Figure 5 The cumulative real GDP growth in different regions in Europe (1995=100) (authors calculations from Eurostat, 2005).



As an example about the market potential the growth of automotive market could be used. The combined GDP of the new member states is broadly comparable to the Netherlands where in 2003 the car market was 511 000 personal and 96 000 commercial vehicles. The

combined figure for the all new members was 800 000 and 115 000 respectively (Rhys, 2004). But the potential is huge. For example Spain and Poland are countries with the similar population, but in 2002 Spanish registrations were 1 332000 cars and 306 000 commercial vehicles compared with Poland at 308 000 and 17 000 respectively. (Rhys, 2004). Supposing that the income level convergence to the current Spanish level would take around 15-20 years the growth of purchasing power could produce extra demand of around 50- 70 000 cars per year alone in Poland.

The enlargement and the factor movements – the new member states as the investment target

The question about the role of enlargement to the factor movements is very broad and covers the accumulation effect problems of regional integration. In general it consist of two sub problems - first is about the impact of enlargement on the movement of capital, mainly in the form of foreign direct investments and second is about the labour reallocation between countries. The labour movement issue is related with the problem of labour cost differential and will be covered separately in the next section. By the discussion about the impact of enlargement on the movement of foreign direct investments is important to control about the diversion of FDI from the EU-15 in favour of new member states. Which countries may loose attractiveness to the FDI and which sectors may be more affected?

The following table 2 describes the inflow of foreign direct investments into the EU-15, new member's states and cohesion countries Spain, Portugal and Greece during the pre-enlargement period 1999-2003. The first conclusion from table is that the fear of relocation of FDI from old member states in favour of new entrants is not supported by the facts. The share of FDI to the accession countries from the total inflow to the EU-15 was in 1999 only 4.6 % and by the 2003 the ratio has grown to the 5.5 %.

Table 2 FDI inflow into EU, new member states and Portugal, Greece, Spain. (Billion USD)

	1999	2000	2001	2002	2003	Total 1999-2003
EU-15	479.37	671.42	357.44	374.0	295.15	2177.4
AC*	22.15	23.72	21.95	25.83	16.32	110.0
Spain	15.76	37.52	28.0	35.9	25.6	142.8
Portugal	1.23	6.78	5.89	1.84	0.96	16.7
Greece	0.57	1.09	1.56	0.05	0.05	3.3
Czech R.	6.31	4.98	5.64	8.48	2.58	28.0
Hungary	3.31	2.76	3.94	2.85	2.47	15.3
Poland	7.27	9.34	5.71	4.13	4.23	30.7
Slovak R.	0.43	1.93	1.58	4.12	0.57	8.6
Estonia	0.30	0.39	0.54	0.29	0.89	2.4

*AC- accession countries including also Romania, Bulgaria, Croatia

Source: World Investment Report, 2004.

Basically EU-15 has remained attractive location of investments, but some countries in the periphery of EU performed really poorly. Greece has been exceptionally weak in attracting new FDI. Within the observed five years period it has received almost the same amount of FDI as Estonia and 8 times less than Czech Republic. Another country facing reducing investments is Portugal, where the annual inflows in 2002 and 2003 were 3-4 times less than in Czech Republic or Hungary. This is an indicator which shows that new member states have competitive advantages as the location of production compared with European south. For example Braconier and Ekholm, (2001) revealed some evidence on the diversion of FDI flows away from Southern Europe and towards the new member states, based on a firm-level dataset on the operations of Swedish multinational companies. They show that the expansion in affiliate-firm employment in CEE countries, which totalled 15,000 over the

period 1990 to 1998, came at the expense of affiliate activity in Southern Europe where employment fell by 14,000. But several works by the Koenings, 2001; Koenings and Murphy, 2003 showed that relocation of labour in affiliates of multinationals and their investments is in favour of the European north. Several papers have shown that the integration process in Europe has been associated with the reallocation of production, but in favour of North European locations.

Following part of the section is devoted to the analyses of relocation in the two industries – automotives and textile and clothing. Automotive industry is high value added, highly complex production system, high skilled labour intensive and demanding on the logistics infrastructure. Textiles and clothing industry is low skilled labour intensive, low value added and has strong limitations in increasing capital-labour ratio. International automotive multinational companies started to invest into new member states since early 1990s (Volkswagen Group, General Motors, Ford), but the intensity of investments has grown explosively during last five years. The major factor of attractiveness is the strategic location close to the major European markets, supply of skilled labour, excellent ratio between productivity and costs and more liberal labour regulations. The following table 3 presents information about the major investments into the region and it reflects also the major destinations of investments.

The future European major car producing regions is going to be Czech Republic, Slovakia, southern Poland and Northern Hungary. In 2001 was started in Kolin, Czech Republic one of the largest greenfield automotive investments ever made in Europe by PSA and Toyota. In 2005 production started and this will likely attract more investment into component firms in the whole region. For example in 2002 out of 153 automotive component investment projects in Europe, the main beneficiary was the Czech Republic with 18 per cent of the total, followed by the UK (13 %) and France (12%). (Rhys, 2004)

Table 3 Investments into automotive industry of EU new member states.

Country	Company	Date of production started, capacity per year
Czech Republic	VW	1991 buying Skoda , capacity 400 000
	VW	1991 joint venture BAZ cars
	PSA Toyota	2005, cars 300 000
Slovakia	VW	1992 , cars 250 000
	PSA	2006, cars 300 000
	Huynдай	2007, cars 300 000
Poland	GM	1992/1998, cars 200 000
	Fiat	1990, cars 200 000
	Ford	1992; components
	Isuzu (GM)	2006, cars 250 000
	Toyota	2004, cars 250 000
	Fiat	2007, engines 500 000
	Toyota	2006, engines 500 000
Hungary	VW	1993, engines 1,22 mill.
	GM	1992, engines 400 000
	Suzuki	1992, cars 100 000
	VW(Audi)	2006, engines 400 000
	Citroen	2006, gearboxes 300 000
Slovenia	Renault	1992, cars 170 000

Source: compiled by author from data in Rhys, 2004: 889-892 and Eurostat.

Specific is that the engineering and designing of cars is moving to the region as well. These plants in the new member states will supply the growing domestic market of new member states but also EU-15. The export orientation of the automotive industry of new member states is rapidly increasing. Following table 4 reveals that between 1995 and 2003 the export

growth of the automotive products from the Slovak Republic increased 17.2, Hungary 10.9, Poland 7.1 and Czech Republic 5.2 times. Consequently the ability to sell is growing and it reflects the growth of competitiveness of the industry not only on the EU, but also on the world market.

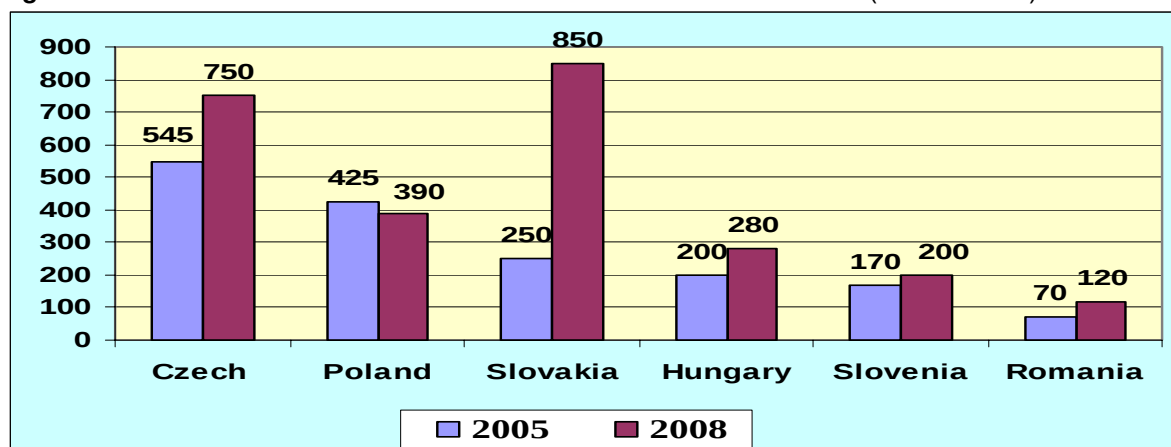
Table 4 Automotive products export from the new EU member states in 1995-2003 (annually in billion USD)

	1995	2001	2002	2003	2003/1995
Czech Rep.	1509	5521	6403	7869	5.2
Hungary	659	5323	5983	7209	10.9
Poland	996	4228	5192	7118	7.1
Slovak Rep.	344	2273	2805	5909	17.2
Slovenia	970	1083	1312	1528	1.6
TOTAL	4478	18428	21695	29633	6.6

Source: author calculations from the WTO database.

In 2003 from the EU-15 total import of automotive products the share of new member states was 7.8 compared with the 5.5 % import share of Japan or 2.4 % of US. (WTO, 2005). Inflow of foreign direct investments into the automotive industry in the new member states will result in the extremely rapid growth in the capacity to produce cars in the region. Following figure describes the growth of production cars in the 6 Central European countries. Between 2005 and 2008 the total production capacity will grow from the 1.66 to 2.59 million cars or 56 %. In general it means that the emergence of Central Europe as the production centre will help to support the competitiveness of the European Union main producers on the world market.

Figure 6 Produced cars in the new EU member states 2005 and 2008 (in thousands)



Source: Rhys, 2004: 889.

The complementarity between the EU-15 main producers and new member states are clearly visible. From the EU side the technological, organisational, distributional knowledge and from the new member states skilled labour, high working motivation and better macroeconomic environment.

Completely different factors are relevant by the investments into the clothing and textile sector. The new member states are more specialised on the textiles, clothing and footwear sector than the EU countries. In 2002 this sector produced 8.3 % of the total manufacturing production and gave 20 % of manufacturing employment in accession countries, compared to 5.2 and 9.3 per cent respectively in the EU-15 (see Table 5).

Table 5 The role of textiles, clothing and footwear industries in the accession countries and the EU, 2000

	Production mn. EUR	Production ¹		Employment		Productivity Th. EUR
		share of GDP (%)	Share of manufacturing (%)	Ths. Persons	Share of manufacturing (%)	
Bulgaria	833.4	5.0	9.8	173.7	31.2	4.8
Czech Rep.	2327.1	3.2	4.1	107.0	10.3	21.7
Estonia²	393.6	7.0	13.6	24.7	21.1	15.9
Hungary³	1687.6	2.9	3.8	119.3	15.9	14.1
Latvia³	287.9	3.4	8.8	24.8	16.8	11.6
Lithuania²	951.9	7.9	16.7	61.0	26.1	15.6
Poland	5493.9	2.7	4.8	289.7	13.1	19.0
Romania	2830	5.8	8.9	452.5	29.6	6.3
Slovak Rep.	695.4	2.8	4.1	63.3	16.7	11.0
Slovenia	1041.9	4.8	8.0	36.9	16.3	28.3
AC-10	16542.7	4.6	8.3	1352.9	19.7	12.2
Greece²	2497.4	2.0	10.4	38.8	18.3	64.3
Ireland²	1002.5	1.0	1.2	15.9	6.0	63.2
Portugal²	10185.1	8.8	15.6	302.7	32.3	33.6
Spain²	22252.2	3.7	6.2	322.4	12.4	69.0
EU-15²	237288.9	2.84	5.24	2479.5	9.34	95.7
AC-10 in per cent of EU-15	7.0			54.6		12.8

Notes 1) At current prices and exchange rates, 2) 2000; 3) 2001; 4) unweighted average

Source: Hanzl-Weiss, D: 930.

The highest is the role of this sector in the total manufacturing in Baltic's, Bulgaria, and Romania and also in Slovenia. But in terms of employment, all countries of the region have very large shares, measuring between 10 per cent in the Czech Republic and 30 per cent in Romania and Bulgaria. Among the EU-15 countries the textile and clothing sector plays important role in Portugal and Greece. Portugal is the country with the highest share of clothing, textile and footwear in employment with 32.3% of total manufacturing employment.

In the textile and clothing sector the behaviour of investors has been still rather different from the automotive industry. Instead of strategic investments made into new member states by automotive multinationals the European clothing and textile firms have used widely outward processing as the market entry method. As the production of textile and clothing industry is highly labour intensive the outward processing allowed producers from EU-15 reduce labour costs and therefore regain competitiveness. In return the new member states producers got guaranteed market access, the acquisition of certain managerial and technical know-how. But in long run their situation is going to deteriorate as the preferred market access to EU market against third world producers disappeared since 2005, when according to the WTO Agreement of Clothing and Textiles European Union market was opened completely,

Inside the European Union the Germany has used Poland as the major outward processing target, Italy and France used Romania and Nordic countries heavily relying on Baltic's. Completely different is situation with the EU-southern periphery countries Portugal, Greece and Spain. Due to the lower pressure of labour costs these countries have not used the outward processing and these countries themselves have been preferred targets of outward processing. The future competitiveness of Portugal, Spain, and Greece in clothing and

textiles is seriously under threat, but according to the following table 6 not as much from the new member states.

Table 6 Competitiveness of new members states in the clothing sector inside the European Union

Country	Value added per employee Portugal=1	Labour costs per employee Portugal=1	Competitive position against Portugal (Productivity – labour costs)	Number of employees in clothing	Employees in clothing from total manufacturing (%)
Denmark	5.01	4.11	0.90	3704	0.8
Italy	2.96	2.06	0.90	290925	6.1
Sweden	2.92	2.31	0.62	3590	0.5
Finland	3.72	3.35	0.36	6054	1.4
Germany	4.23	3.89	0.34	65852	0.9
Spain	2.20	1.89	0.31	119925	4.6
France	3.86	3.63	0.23	92454	2.3
Czech R	0.59	0.50	0.09	55209	4.0
Romania	0.25	0.21	0.04	324867	18.3
Lithuania	0.41	0.38	0.03	41963	16.8
Bulgaria	0.17	0.16	0.01	135516	22.0
Estonia	0.54	0.54	0.00	13996	11.0
Portugal	1.00	1.00	0.00	147817	16.2
Ireland	3.05	3.09	-0.04	3178	1.3
Hungary	0.51	0.55	-0.04	72304	8.1
Slovakia	0.40	0.45	-0.05	28764	7.0
Slovenia	0.95	1.11	-0.16	16637	6.5
Poland	0.53	0.84	-0.30	184476	7.7

Source; calculated by author from Eurostat, 2006.

Table 6 is comparing the competitive position of Portuguese clothing industry against the competitors inside the EU. The value added per employee in Portugal was taken equal to the unit and other countries were compared with it. The highest value added was in Denmark (5 times above Portugal level) and labour costs were 4.11 times above Portugal level. Therefore competitiveness of the remaining extremely small Danish clothing industry employing only 0.8 % of all manufacturing industry is very high. But in Italy 6.1 % of employment was in clothing and their value added was 2.96 times above Portugal and labour costs 2.06 times, which indicates that Italian clothing industry is clearly more competitive. The clothing industries from the new member states are not competitive compared with Portugal.

The labour costs advantage is lost by the productivity gap and only in case of Romania, Lithuania and Estonia the competitive position against Portugal is strong. Table clearly indicates that majority of new member states, but first of all Slovenia, Poland, Slovakia could not compete as the labour costs are too high by the current productivity level. The liberalisation of EU market since 2005 will further reduce the competitiveness of this sector in those countries and consequently the shift in production structure is inevitable. The conclusion is that the new member states are competitors inside EU in textile and clothing sector only in limited sense as the major competitors are from China, India or Pakistan, with labour costs 0.5 USD per hours against 20 USD in EU-15.

Inside the European Union the relative competitiveness of certain countries after the enlargement is going to change. This process has started already since the beginning of

transition in Central and Eastern Europe. The strict requirements to the new entrants set by the enlargement negotiations have facilitated the rapid growth of competitiveness of EU new member states on the European and world market. This process has been fast and the previous cohesion countries Portugal, Greece and in certain sectors also Spain and the whole agricultural sector in the EU-15 are facing strong competitive pressure after enlargement. Actually this process started already earlier. As an example results from Crespo et al (2004) may be used. They divided export products into three categories (see details in Crespo et al, 2004) and calculated the structure of trade in southern EU-15 countries and in some new member states.

Table 7 Export to EU by the technological level in 1995 and 2000 (share in % of total exports)

	1995			2000		
	High	Medium	Low	High	Medium	Low
Czech Rep.	22.7	28.1	49.2	29.9	39.0	31.1
Hungary	24.4	31.4	44.2	44.0	34.2	21.8
Poland	13.5	26.8	59.7	18.9	33.0	48.1
CEEC (10)	17.1	27.5	55.4	27.0	32.3	40.7
Ireland	45.6	20.6	33.8	54.9	29.0	16.1
Greece	7.8	13.4	78.8	9.7	14.2	76.1
Spain	15.9	46.6	37.5	17.9	46.7	35.4
Portugal	20.4	21.1	58.5	21.8	27.1	51.1

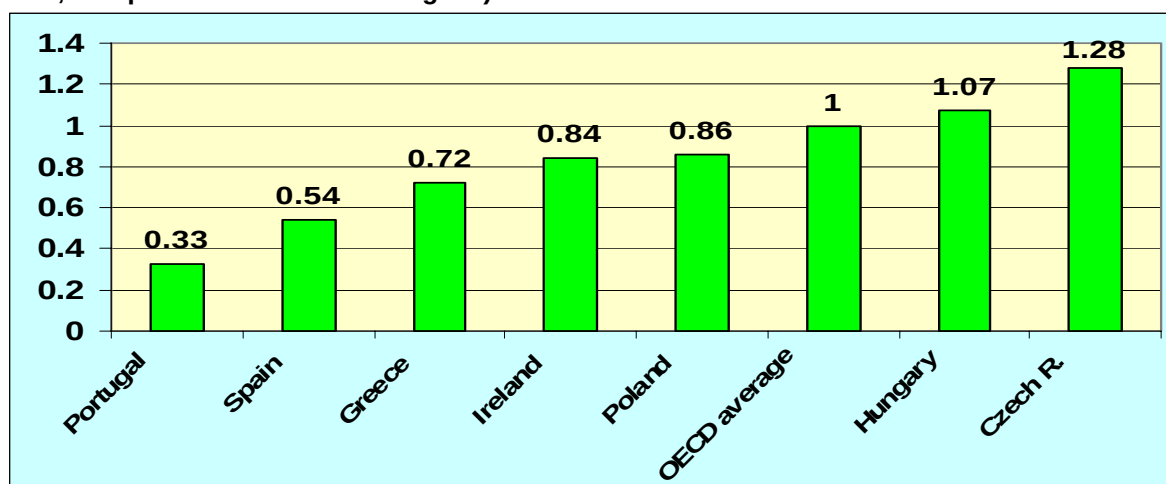
Source: Crespo et al, 2004, p.788.

During 1995-2000 the structure of new member states improved rapidly as the weight of high technology sectors increased from 17 to 27 per cent in average of the all ten new member states. In 2000 the low technology exports represented more than 50 per cent of total Portuguese exports compared with the new member states average of 40.7 per cent. Particularly striking is to compare the Hungary, where the figure was as low as 21.8 per cent with Greece 76.1 %. Ireland is a special case with 54.9 per cent of total exports coming from high technology sectors. The dynamics of improvement of the export structure is also in favour of Hungary and Czech Republic compared with Portugal or Greece. Within 1995 to 2000 the share of high technology exports increased by 19.6 % and 7.2 % in these countries. In Portugal the share remained unchanged and in Greece increased by 2.1 %. Only in Poland the change has been slower, but 11% of reduction of low-technology products is still positive change. Therefore the structural change in new member's states and growth of competition on the EU internal market would increase the ability to adjust also in the older EU member states and will push structural change also in southern EU member states. But the ability to implement these changes depends critically on the earlier investments into human capital and knowledge intensive sectors of economy.

Human capital of the new member states as the support factor to the European competitiveness

The quality of human capital available in the new member states is an asset which supports the future growth of Europe and is an important push factor for outward investments from the EU-15. The following figure 7 illustrates the quality of labour in the new member states compared with the previous EU entrants (Portugal, Greece, and Spain). On the figure 7 units represents the OECD average level of the population that has attained at least upper secondary level among aged 25-64 in 1998. In Portugal this share was three and in Spain two times below the OECD average. In the same time the Czech level was 28 % and in Hungary 7 % above the OECD average.

Figure 7 Population that has attained at least upper secondary level among aged 25-64 (in 1998, compared with OECD average=1).



Source: Barry 2004: 754.

But in order to get some dynamics about the educational attainment of population aged 25 to 64 having completed at least upper secondary education following table 8 was constructed.

Table 8. Total population having completed at least upper secondary education (in % among population aged 25 to 64, %)

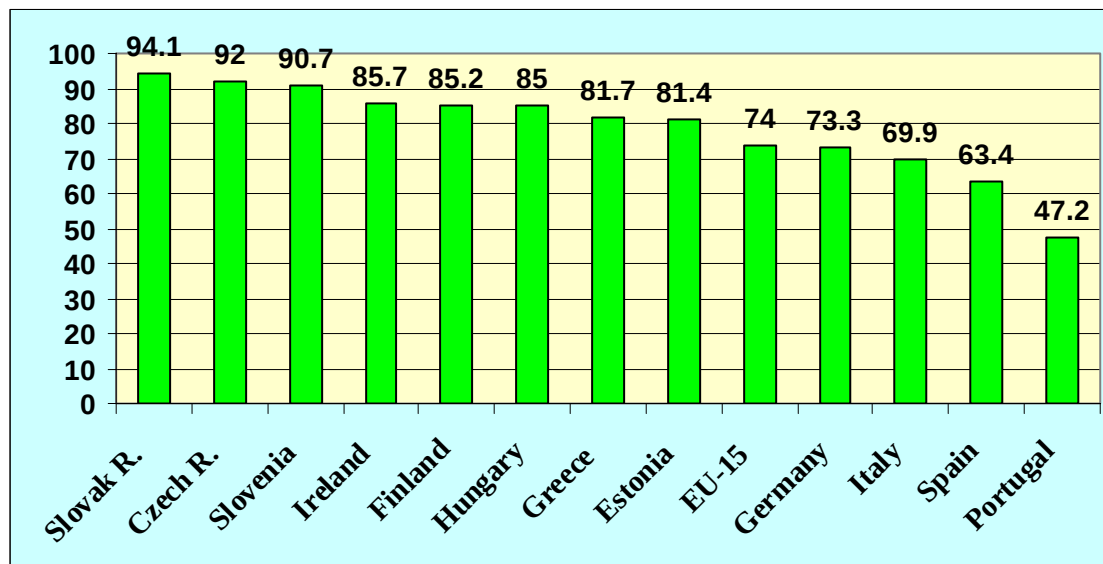
	1992	1998	1999	2000	2001	2002
EU (15 countries)	51	61.5	62.2	63.4	63.8	64.6
Greece	36.6	47.5	49.9	51.2	51.6	52.7
Spain	24.0	34.4	36.1	38.3	40.0	41.6
Ireland	42.3	n.a	n.a	57.5	59.0	60.3
Portugal	19.9	19.9	19.2	19.6	19.9	20.6
Czech Republic	n.a	85.6	86.0	86.1	86.3	87.8
Estonia	n.a	83.9	84.8	84.7	86.0	87.5
Latvia	n.a	82.6	83.5	83.1	79.1	82.6
Lithuania	n.a	78.4	79.4	84.9	84.4	84.8
Hungary	n.a	67.3	73.2	69.2	70.1	71.4
Poland	n.a	77.8	78.5	79.7	80.0	80.8
Slovenia	n.a	72.5	74.0	74.8	75.4	76.8
Slovakia	n.a	80.0	82.1	83.6	84.9	85.8
Bulgaria	n.a	n.a	n.a	67.1	71.1	71.5
Romania	n.a	66.9	68.0	69.3	70.5	71.1

Source: Eurostat, 2006.

It has data about the new member states and previous cohesion countries from 1992 and 2002. The results of the table are supporting the previous findings about the generally high educational background of the population in new member states compared with Portugal, Greece or Spain. Particularly amazing is the slow progress of Portugal by this indicator. There has been no change at all during the decade in educational attainment in Portugal, remaining as low as 20.6 %, three times below the new member states averages.

Another extremely revealing factor indicating the threat of new member states to the Portugal, Spain, Greece is the data about the educational situation within the age group 18-24. The following figure 8 presents data about the percentage of population aged 20-24 having completed at least upper secondary education. The figure indicates the potential of new member states also from the future generation of well educated youth. The comparison with EU-15 average indicates that all new member states had higher level than EU-15.

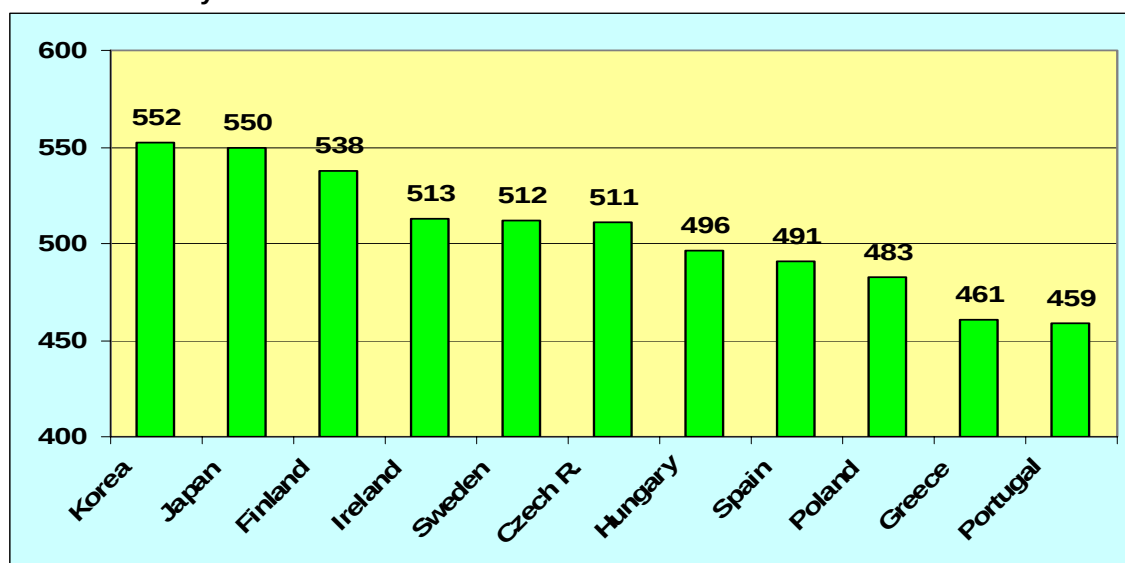
Figure 8 The percentage of population aged 20-24 having completed at least upper secondary education



Source: Eurostat, 2005.

Finally the level of educational quality on the high school level was analysed. For this purpose results of the OECD PISA (Programme for International Student Assessment) from 2000 were used. Among several indicators the scientific literacy index was calculated based on the skills of student to recognise and tackle scientific questions, select relevant information from competing data and relate this information to knowledge acquired previously. Following figure 9 is giving the position of new member states participating in this project compared with the southern EU states and also top performers of PISA 2000. Results are indicating that the current secondary school system is producing better education in the new member states compared with Portugal or Greece. Based on all this information the potential of the new member states to be able to adjust and compete is much better than by certain EU-15 members. In general the enlargement has brought into European Union countries which labour force in general is at least on the similar level of educational the labour in EU-15, but their wage level is only one third of EU average. Consequently the qualification to labour costs ratio is favourable and supports the competitiveness of Europe on the global market.

Figure 9 OECD PISA (Programme for International Student Assessment) results by the scientific literacy index



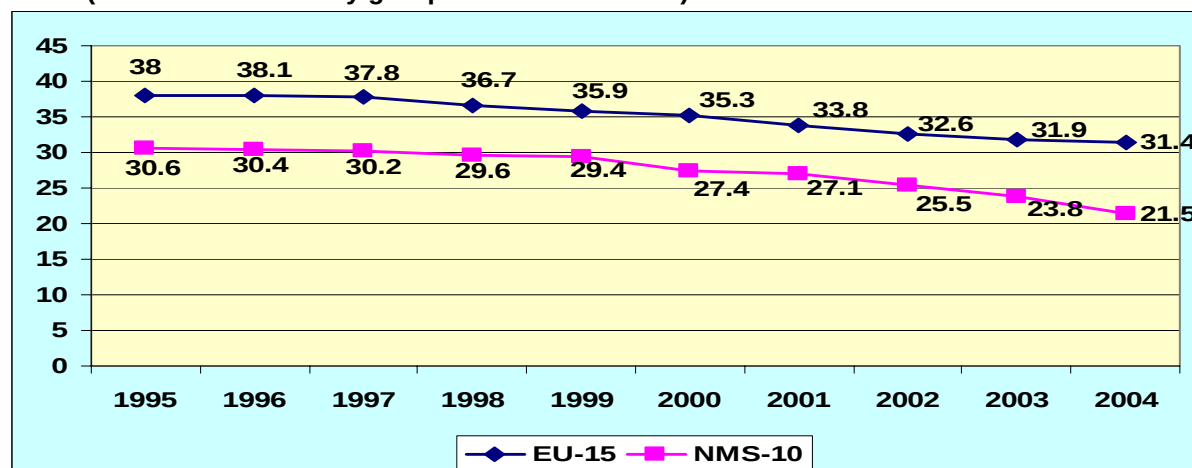
Source: Välijärvi et al, 2002.

Enlargement as the process of encouraging the liberalization inside the European Union

Enlargement has brought into European Union a group of countries which have faced need to reform their economic and social system from the very fundamentals. Therefore they had much more freedom to implement new and liberal ideas in the economic and social policy areas. This liberal mindset of new member states could start to influence also changes in the general mindset toward reforms needed in economic and social policy in European Union as the whole.

As an example of this process only the impact of liberal tax policy on the competitiveness of Europe will be covered shortly. The tax systems in the new member states of the European Union emerged through the profound reforms and their general orientation has been during the past decade to reduce the direct taxes, particularly personal and corporate income taxes and shift the tax burden toward indirect taxes. The most radical reform was introduced in Slovakia in 2003. The core underlying principle of the tax reform was to implement the flat 19 % tax rate throughout the economy - personal and corporate income tax as well value added tax. Actually the same trend is also in EU as a whole, but in certain degree the tax policy of new member states as frontrunners has created incentives also to revise the taxation policy in EU-15. On the following figure 10 is given the trend of the effective statutory level of corporate income tax in the new member states and in EU-15 between 1995 and 2004.

Figure 10 Effective top statutory tax rate on corporate income in EU-15 and EU10new member states (arithmetical mean by groups of countries in %)



Source: Tax, 2004.

The same declining trend could be followed, but the gap between tax rates in two groups has increased from 7.4 percentage points in 1995 to 9.9 p.p in 2004.

The taxation policy on new member states about the income taxes have been in line with the tax policy changes in Anglo-American countries. In some sense their policy particularly in reducing corporate income tax levels has been understood by as threatening the current taxation policy trends of major continental European countries. But on the other hand the new member states have very high taxation of labour as the result of extremely high social security taxation level paid by employers and also heavy health insurance tax. According to the European Commission assessment the tax wedge on total labour cost in a number of new member states (Hungary, Latvia, and Lithuania) are among the highest in Europe and comparable with France, Germany or Sweden levels. In 2000 the wedge for an average production worker in nine of the acceding countries (except Slovenia) averaged about 45.7 per cent, with the highest (52 per cent) in Hungary and the lowest in Estonia and Slovakia (42 per cent). For comparison, the highest tax wedge in the EU was in Belgium (56 per cent) and the lowest in Ireland (29 per cent). (See page 130 in EC Survey 2004).

Therefore the new member states are interesting mix of Anglo-American liberalism in the sense of low personal and corporate income tax and on the other hand having very high social security tax level characteristic to the Scandinavian welfare states. In the context of competitiveness of Europe on the world scale the major issue is how sustainable could be to continue the current taxation policy, which is driven not only by considerations of economic efficiency but also by concerns about social cohesion, equity and justice. (See Tax reforms, 2004). The enlargement has brought along the need to revise the general understanding about the taxation policy used in Europe and the attempts from the France or Italy to force new member states to fix certain required level of taxes has not succeeded. In general this liberalisation mindset will be positive for the future competitiveness of Europe and helps to increase ability of Europe to attract investments. It is a precondition for Europe to be able to adjust in the changing world.

Conclusions

The article was trying to explain the impact of enlargement on the competitiveness of European Union on the world market and on the competitiveness of EU-15 against the new member states. In the theoretical part of the article was concluding that the competitiveness of a nation is a hierarchical system, where economic competitiveness is located in the

basement. It consists of three components - ability to sell, ability to adjust and ability to attract, which all together create the ability of the country to earn, which is located on the higher level of the hierarchy of competitiveness. Applying the competitiveness model described in the theoretical part on the EU and US clearly indicated that EU-15 has been trading off ability to earn against welfare objectives.

The following part of the paper argued that the impact of EU enlargement on the competitiveness on the world market is positive due to supporting ability to sell by providing growing market and supplying inexpensive skilled labour. Enlargement also support ability to adjust by adding countries with more flexible system of taxation and labour market regulations. The enlargement will also increase competition between the old and new member states of EU. The analyses revealed that the impact of enlargement on the competitiveness of EU-15 is country group dependant. The Nordic countries are better prepared themselves to compete on the liberalised EU internal market and invested heavily into the future growth, which creates flexibility and ability to adjust. The new member states are used by Nordic countries mainly as the complementary factor, which helps to compete on the world market. Reallocation of labour intensive industries into new member states is pushing the domestic industry and service sector in Nordic countries to increase the value added content. But the weakest is the position of southern periphery countries of EU, which will face the entry of the new member states as substitution effect. Substitution means that the new member states are offering goods and services, which are with the relatively similar factor intensities than they could provide. Southern EU countries have much lower ability to adjust as their human capital is weaker and they have invested less than Nordic countries into the future growth. The competition will force Southern periphery and also continental European countries to invest into future growth.

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Section 2

Industrial relocation in enlarged Europe

Social dumping: Practice adopted by certain countries of offering low wage costs in order to attract foreign investment. It is particularly worrying for countries (such as those of Western Europe) which, because of their long tradition of trade-unionism, have attained better living and working conditions and so have much higher labour costs. (European Foundation for the Improvement of Living and Working Conditions, contribution by Spain, n.a.)

'Dumping' claims are just rubbish (Oliver O'Connor in *Irish Times*, 1998, October 30)

Investment creation and diversion in an integrating Europe

Kálmán Kalotay¹³

United Nations Conference on Trade and Development, Geneva, Switzerland

Abstract

This paper explores how the current and forthcoming expansions of the European Union (EU) affect foreign direct investment (FDI) inflows in the European continent. The analysis will use the theory of investment creation/diversion/restructuring, developed by Dunning & Robson (1998) as an extension of Viner's (1950) trade theory (trade creation versus trade diversion). Using in particular the experience of Hungary with relocations to illustrate its main point, it concludes that investment creation in Europe is rather weak, and hence is not expected to contribute to the EU's declared ambition to become the most competitive economy in the world. Moreover, the political turmoil of some new EU member countries in 2006 (in particular Hungary) indicates that a lack of effective restructuring in the expanded EU can cause dissatisfaction in countries expected to catch up with the EU-15 in a short period of time but not having the full possibilities to gain the productive capacities to do that.

JEL classification: F23, O52, F15, J31, H32

Keywords: European Union, foreign direct investment, enlargement, labour productivity, tax competition, investment creation/diversion

¹³ Economic Affairs Officer. The views are those of the author and do not necessarily represent the opinion of the United Nations. E-mail: kalman.kalotay@unctad.org

EU expansions and the economic integration of the European continent

In May 2004, the membership of the European Union increased from 15 to 25 countries. Since the signature of the treaty of Rome in 1957 by its six founding members, the EU had never accepted such an unprecedented number of new members (table 1). And, with the exception of the integration of the new German Länder in 1991, this was the first time that the territory of the EU was extended – massively – beyond the former Iron Curtain. The enlargement of the EU is not yet necessarily complete. There are at least four countries that are officially recognized as candidates for membership (table 1). Two of them, Bulgaria and Romania are already negotiating the terms of their accession. Croatia may follow suit soon. Nevertheless, it is not likely that any future enlargement would bring in as many new members as the one in May 2004.

Table 1 The expansion of the European Union, 1958-2004

Country/territory	Year joined	Group	Country/territory	Year joined	Group
Belgium	1958	EU-15	Sweden	1995	EU-15
Federal Republic of Germany	1958	EU-15	Cyprus	2004	New member
France	1958	EU-15	Czech Republic	2004	New member
Italy	1958	EU-15	Estonia	2004	New member
Luxembourg	1958	EU-15	Hungary	2004	New member
The Netherlands	1958	EU-15	Latvia	2004	New member
Denmark	1973	EU-15	Lithuania	2004	New member
Ireland	1973	EU-15	Malta	2004	New member
United Kingdom	1973	EU-15	Poland	2004	New member
Greece	1981	EU-15	Slovakia	2004	New member
Portugal	1986	EU-15	Slovenia	2004	New member
Spain	1986	EU-15	Bulgaria	Not yet (2007)	Candidate
New German Länder	1991	EU-15	Croatia	Not yet	Candidate
Austria	1995	EU-15	Romania	Not yet (2007)	Candidate
Finland	1995	EU-15	Turkey	Not yet	Candidate

Source: Author's collection

The enlarged EU of 2004 has an economic power comparable with that of other major integration groupings such as the North American Free Trade Area (NAFTA) or the Association of South-East Asian Nations (ASEAN). Enlargement has increased the EU's population from 377 to 451 million (+74 million). This is higher than the population of NAFTA (413 million), although still less than that of ASEAN (521 million). The gross domestic product (GDP) of the enlarged EU increased only marginally, from US\$7.9 trillion to US\$8.2 trillion (+US\$0.3 trillion only), due to the relatively low GDP per capita of the new members. But income levels are expected to rise fast in the new EU, making it possible to close on with the NAFTA, which, with a combined GDP of US\$11 trillion, is today still ahead. (As for the ASEAN, the total GDP of that developing country group remains under US\$1 trillion.) Compared to its peers, the EU possesses a major qualitative advantage: its integration processes are deeper and more comprehensive than those of the NAFTA and the ASEAN. The EU is a customs and (potentially) economic union, with free movement of people (after a transition period), capital, goods and services. Compared with that, the NAFTA is only a free trade area, although it has side agreements on environment and labour. As for ASEAN, it is a de facto preferential trade area. This level of integration of the EU area, which could be denoted as deep integration, in contrast to the shallow (trade-based) integration of other groupings (UNCTAD, 1993, 113), should be a major direct attraction for EU-based transnational corporations (TNCs) and a major indirect attraction for external investors. In principle, new EU members could be attractive for foreign direct investment (FDI), as they

successfully combine access to a large single market (with a high purchasing power) and efficient locations. However, these favourable circumstances do not automatically translate to more FDI. The political consequences of a delayed restructuring manifested themselves, among other things, in a political turmoil in some new EU member countries in 2006 (in particular Hungary). Dissatisfaction of the public in those countries expected to catch up with the EU-15 in a short period of time but not having the full possibilities to gain the productive capacities to do that led to strong social responses, including violence in Hungary in September 2006. This article will document why that reality is more complex than theory would suggest.

While the economic case for European integration is very solid, the future deepening and/or broadening of the EU will be decided on different grounds. So far, all decisions in this respect have been political or politically motivated. In turn, political decision making has been, and very probably will be, influenced largely by non-economic (social, cultural) factors. Social and cultural integration is naturally more difficult to measure than economic integration. It would seem from mostly anecdotal evidence such as the dynamics of French and Dutch public opinion vis-à-vis the referendum on the EU constitution that there the processes of European unification are slower and more uneven than economic integration. As this is not a full-fledged social analysis, it can only highlight some key issues that can act as a backlash against economic integration, such as the social and political reaction in the EU-15 to relocation of economic activities to new member countries and outside locations (especially in South and East Asia). In particular, the lack of differentiation between the two, while understandable, may indicate a lack of feeling for intra-EU solidarity ('they are not us'). In light of the events of 2006, these attitudes need to be seen as a source of pan-European instability.

Another, related issue is the question of where Europe ends (the dilemma of the broadeners), and how an enlarged Europe would and could deal with the outside world, especially its 'new neighbourhood'/new frontier'. As 'Europe' is a social construct (in pure geographical terms it is not a continent but a peninsula of Asia), it is only question of social consensus to decide where the borders are. This is a particularly sensitive issue for countries that are on the border line, and whose future hinges on this social dimension. Depending on these social decisions, one should differentiate between the insiders of the Union (the EU-25 plus the accession countries of Bulgaria and Romania), the quasi, or almost, insiders (the EEA and Turkey), the potential insiders (South-East Europe) and those that will surely remain outsiders (The Southern Mediterranean and the Russian Federation), plus the cases that are undecided such as Switzerland and Ukraine. This definitional issue is important for three reasons: one, it determines the dynamics of investment creation and diversion: in the short run, adjustments are expected to be stronger in the insider group but the stave off over time, continuing only in emerging economic activities while in the outside group, separated from insiders by tariff and non-tariff barriers, investment creation and diversion are a more constant phenomenon. Two, the influence of the EU on outsiders remains more conditional: for the moment, it seems to be guaranteed in the Mediterranean but not so in the CIS. Third, the definition of borders can affect some strategic economic issues; for instance the fact that the main source of energy (the Russian Federation) remains an outsider has implications for the future of the EU economy in general.

Investment creation and investment diversion

This section focuses on one of the key features of investment creation and investment diversion, namely their relationship with economic efficiency and welfare. The theory of trade creation affirms that economic integration results in trade creation if international trade between the integrating countries themselves increases thanks to a more efficient distribution of economic activities among them. In the Vinerian concepts of *trade* creation versus trade

diversion (Viner, 1950), from which the ideas of investment creation versus diversion could be derived, a key test to determine whether changes in trade flows are of creating or diverting nature is their link with efficiency. If the volume of trade remains unchanged, but a more efficient location replaces a less efficient one, it is considered to be trade creation. This is so because, from a dynamic perspective, an improvement in global efficiency will lead to trade expansion in the longer one, even if the static impact is zero (with both winners and losers). It is a win-win situation because each of the participating countries will increase its output thanks to a better specialization on their comparative advantages, and that will increase overall welfare within the integration grouping. In principle, this can be also true to trade with outside countries, on condition that changes in trade flows are increasing efficiency. Conversely, trade diversion can affect commercial relations with third countries in particular, if global efficiency in the new situation decreases as a result of new trade barriers between parties. In principle, trade diversion can also affect intra-grouping trade if the new situation is less efficient. It has to be noted however that such a situation can take place of non-economic factors such as institutional or political barriers annul the impact of trade creation.

The theory of trade creation can be transferred to investment relations. At the micro level, the three key impacts of extended and/or deepening integration (investment creation, investment diversion, reorganization) can be expected to take place simultaneously, and in all EU member countries (Dunning & Robson, 1988; Baldwin et al., 1996). This theory contains a major extension, namely, that in FDI some of the changes are difficult to classify, and are therefore categorized as reorganization of production. However, reorganization itself is closer in its concepts to investment creation than investment diversion. In addition, the more one goes into the micro level, the more one finds winners and losers in all countries. That is so because the adjustment from one situation under which only 15 high-income countries have free movement of people, capital, goods and services to another one in which 10 lower-income countries are brought into those production networks, carries with itself important changes in the location of economic activities.

Applying these theories to the European continent, one needs to carry out two tests: one, to see which locations are more efficient than others. Second, to test if FDI indeed flows to those locations. In the efficiency test, one can prove that new EU members in particular, have derived their attractiveness for FDI with their relative labour costs, i.e. wages adjusted for productivity. In terms of wages and related policies, there have always been long-standing differences between the high-income and more developed countries of Europe (within and outside the EU), and the less developed, lower wage countries. With the accession of new members to the EU in 2004, discrepancies in wages have further increased. In 2001, the average wage level of the EU-15 was more than three times higher than that of the 10 new member countries (table 2). Adjusted to productivity, new EU member countries offer major labour cost advantages, especially compared to Mediterranean EU members (Greece and Portugal). (See also the similar conclusions by Domański, 2001; Hardy, 1998; and Hunya, 2001.) The only exception is Poland whose average national productivity is low due to weak competitiveness in agriculture. The value added per €1,000 labour costs in Polish agriculture is only €2.6 (Stephan, 2003, p. 76). If only manufacturing and services were counted, however, Poland would have productivity levels similar to those of the other accession countries. It is to be stressed that the labour cost advantage of the new EU member countries is relative, and not absolute. In the European continent, most of the South-East European and CIS countries offer lower wages than the new EU members, and that gap is expected to widen in the future (UNCTAD, 2004, 77). It is even more so when the comparison is made with East Asia. Hence it is not possible to base a long-term development strategy in the new EU member countries on keeping the absolute wages simply as low as possible (cf. Pavlínek, 2004, 53). That does not mean, however, that the relative wage levels (adjusted to productivity) would lose importance. On the contrary, job

creation and economic development will remain possible in the new EU member countries only if wages do not increase faster than productivity.

Table 2 Gross monthly average salary in selected economies, adjusted to productivity, 1999-2002 (Euros and percentage).

Country	Gross monthly average salary				Productivity ^a 2000	Productivity/ salary (EU-15=100%) 2000
	1999	2000	2001	2002		
Average of the EU-15^b	1 923	2 127	2 191	..	42.5	100
Of which:						
Greece	1 160	1 227	1 286	1 357	19.4	79
Portugal	..	1 052	1 112	..	10.0	48
Spain	1 297	1 326	1 372	1 425	26.1	98
New EU members^c	381	410	460	..	11,7	117
Of which:						
Czech Republic	343	379	430	510	10,9	144
Estonia	282	303	328	..	8,3	137
Hungary	314	348	408	489	11,1	160
Latvia	257	277	280	..	..	..
Lithuania	251	270	300	..	..	..
Poland	442	471	626	598	9,3	99
Slovakia	260	299	320	382	9,2	154
Slovenia	895	935	988	1 041	21,3	114
EU candidates	115	132	146	153	..	..
Of which:						
Bulgaria	111	120	127	132	..	..
Romania	120	144	165	174	..	..

Source: Author's calculation, based on <http://europa.eu.int/comm/eurostat/>; <http://www.dree.org/elargissement> (data in italics); and Stephan, 2003, 10 (for productivity data).

^a Value added per €1000 labour costs, national average.

^b EUROSTAT estimate. Data for Austria, Ireland and Italy are not available.

^c Average productivity is based on data for the Czech Republic, Estonia, Hungary, Poland, Slovakia and Slovenia only.

It is also shown that new EU members, Bulgaria and Romania, derive competitiveness only partly from lower corporate taxes, and particularly not from 'social dumping'. Part of the adjustment of national development policies in general, and FDI policies in particular, to EU enlargement in the new member countries came in the form of adjusting the fiscal systems to the new realities of international competition. This was done so because even within the EU, member countries enjoy a high degree of autonomy in setting their corporate tax rates according to their development priorities (Tupy, 2003, p. 1). For example, countries wishing to attain high GDP growth rate at least partly with the involvement of inward FDI, may set the tax rate relatively low, in order to stimulate the reinvestment of earnings into production. In turn, countries with higher GDP per capita levels, lower growth rates and large social safety nets may maximize fiscal revenues by setting their rates relatively high.

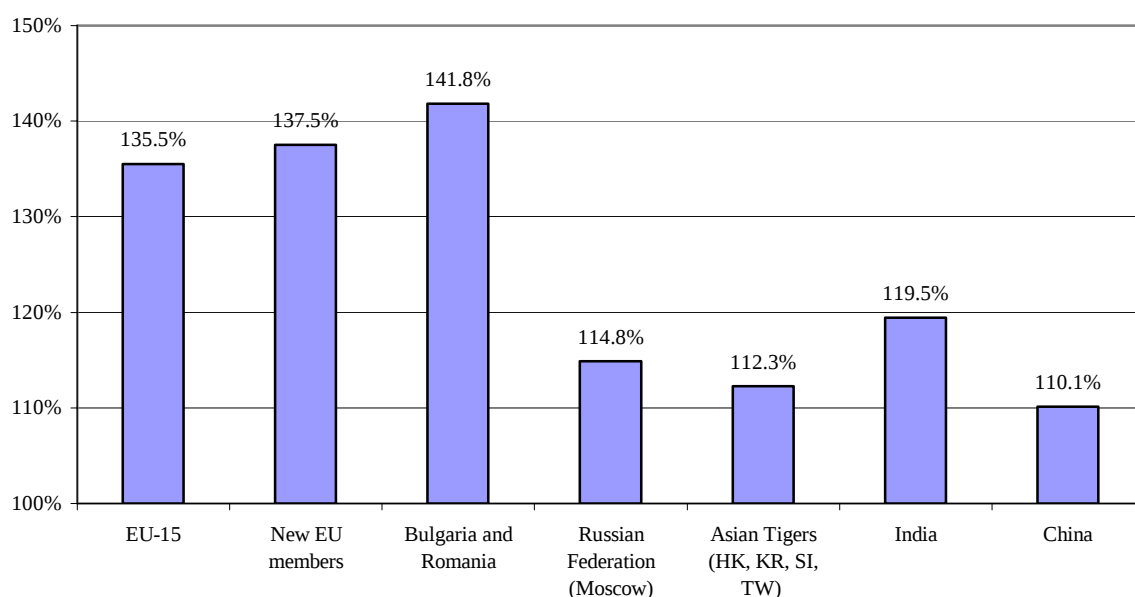
As for corporate taxes within the EU of 25 members, the diversity of national priorities is reflected in the differences of individual levels. Ireland, for example, has one of the lowest corporate tax rates in international comparison, based on a sample of 75 economies.¹⁴ After the wave of tax reductions at the beginning of 2004, the majority of new EU member

¹⁴ The "KPMG's Corporate Tax Rates Survey — 2004" (http://www.kpmg.co.uk/pubs/taxrates_04.pdf) contains information for 69 jurisdictions. In addition, UNCTAD has information for six more countries required to make the comparison complete: Bulgaria, Estonia, Latvia, Lithuania, Malta and Slovenia.

countries, too, belong to this category (with the notable exceptions of Malta, the Czech Republic and Slovenia. In a worldwide comparison, the high-tax EU member countries such as Germany and Italy are at a level similar to other developed countries such as the United States and Japan. However, there are some high-tax economies in South Asia, too (India, Pakistan, Sri Lanka). In turn, the low-tax new EU member countries compare with certain emerging locations such as Chile and Hong Kong (China) and Ireland. These numbers suggest that the corporate tax policies of the new EU members reflect their level of development and development objectives. Lower corporate taxes are also part of the measures aimed to compensate for the relatively high costs of adopting the EU's regulatory standards (see above) and deal with the consequences of the consensus-driven compromise on the application of cohesion policies (UNCTAD, 2003, p. 79, footnote 43).

Data also show that, contrary to widespread perceptions, the social costs of labour in new EU members (and in Bulgaria and Romania) tend to be somewhat *higher*, and not lower, than in the EU-15 (figure 1). . New EU members do not keep their wage cost artificially low by eliminating practices of worker protection. It is a situation very different from outside locations such as the Russian Federation, China and India, where social charges on wages are much lower. Then why the lower wages in the new EU members? They simply reflect the lower level of development, lower absolute labour productivity of those countries, as well as a lower activity rate of population for age 15-64 (55.9% in 2002, as compared to 64.3% in the EU-15, according to Eurostat) and higher unemployment rates (14.8% vs. 7.7% in 2002).

Figure 1 Gross per net wages, average of unskilled and skilled workers, 2004 (ln %).



Source: Author's calculation, based on data from Mercer Human Resource.

It seems that part of the concerns on social dumping stem from unjustified perceptions on what drives the location of FDI. First of all, studies in this respect usually show that when wage differentials are large between two locations are large, "social dumping" matters little in the equation. This is clearly the case between the two groups of EU countries. It has been also shown that the effect of any wage differential is stronger on unskilled labour but limited on skilled labour (Busse, 2002). It has also been shown that the organization of labour per se (basic labour rights) and union intensity or "social wages" have only a negligible effect on locational choices (*idem* and Alderson, 2004). It is only specific issues such as strike intensity that affect significantly the flow of FDI (Alderson, 2004). In other words, the impact

of labour rights and labour organization on FDI is very much differentiated, with basic rights having no measurable negative effects on locational choices.

Within the EU, despite the fact that basic FDI data are publicly available to all users (<http://www.unctad.org/fdistatistics>), there have been relatively few studies prepared comparing the FDI flows of the new EU member countries to those of the EU-15. This may be due to conservatism in the classification of European countries, which has viewed all economies in transition as one bloc, separated from Western Europe, even in the phase leading to the eastern enlargement of the EU. This way of thinking in terms of “western” and “eastern” blocs is one of the lasting heritages of the Cold War. Even the studies that made a comparison with Western Europe (cf. Pavlínek, 2004, 49) used the FDI inflows of the whole CEE, including South-East Europe and the European part of the Commonwealth of Independent States (CIS). Still, the conclusion is clear-cut: the 1990-2001 cumulative inflows of CEE amounted to only 5.7% of the inflows of the European continent.

Once the exercise of comparison is made, it becomes evident that, compared to the competitiveness of new EU member countries, their FDI inflows are surprisingly low. It is even the case of the data are adjusted to the size of the economy. The ten countries that joined the EU on 1 May 2004 have so far neither diverted significant FDI inflows away from the 15 older members of the Union, nor improved their FDI position significantly relative to the older members. Over most of the late-1990s and early 2000s, the combined inflow of the ten new EU member countries remained considerably lower than the inflows of individual EU-member countries such as France and Germany, and, more recently, Ireland and Spain (table 3). Since the mid-1990s, the FDI inflows of the ten new EU members accounted for a fraction of the inflows of the EU 15 – a mere 4% in 2003, declining from a high of 10.7% in 1995. Over the whole period of observation (1995-2004), this percentage remained significantly lower than the ratio of population between new and “old” EU members (about 20%). Compared to GDP, the comparison looks slightly better, although in 2000 and 2003, the ratio of inward FDI falls below the ration of GDP. In 2004, FDI in new EU members surged again. That fact, combined with an expected decline in the EU-15 can result in a return to the relative level of 1998 (7%). However, it remains to be confirmed if the recovery in the new EU members will remain sustainable in the longer run.

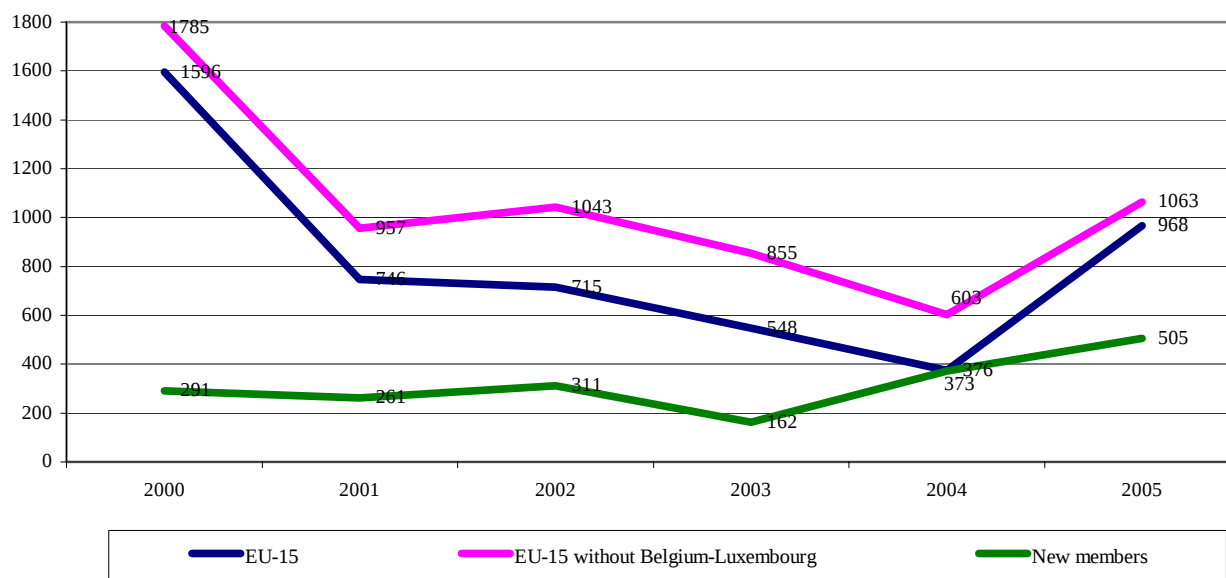
Table 3 FDI inflows of new EU members in international comparison, 1995-2004 (Billion dollars).

Country/group	1995	1998	2000	2001	2002	2003	2004
New EU members	12.2	16.8	20.6	18.6	22.9	11.8	18
Of which:							
Czech Republic	2.6	3.7	5.0	5.6	8.5	2.6	4
Hungary	5.1	3.8	2.8	3.9	2.8	2.5	4
Poland	3.7	6.4	9.3	5.7	4.1	4.2	5
Slovakia	0.3	0.7	1.9	1.6	4.1	0.6	1
Memorandum items:							
World	335.7	690.9	1'388.0	817.6	678.8	559.6	597
EU-15	114.6	249.9	671.4	357.4	374.0	295.2	242
Of which:							
France	23.7	31.0	43.3	50.5	48.9	47.0	26
Germany	12.0	24.6	198.3	21.1	36.0	12.9	-11
Ireland	1.4	8.6	25.8	9.7	24.5	25.5	19
Spain	6.3	11.8	37.5	28.0	35.9	25.6	14
New EU member countries							
per EU-15 (%)	10.7	6.7	3.1	5.2	6.1	4.0	7.4

Source: Author's calculation, based on the UNCTAD, FDI/TNC database.

In terms of FDI inflows per capita, new EU members perform better. Indeed, in 2004, they came to results close to that of the EU-15 excluding Belgium and Luxembourg (figure 2). (That adjustment was necessary because Luxembourg is home to large amounts of trans-shipped FDI (UNCTAD, 2003), under which holding companies headquartered in the territory are recipients of large inflows and outflows simultaneously). In 2005 however, the difference between EU-15 and new EU members increased again, making it difficult to predict any consistent long-term trend.

Figure 2 FDI inflows per capita, 2000-2005 (In US\$).



Source: Author's calculation, based on UNCTAD, FDI/TNC database.

If restructuring were working according to the predictions of standard theories of the international economy, FDI should flow massively to lower-income countries in general and to new members within the enlarged EU in general. This situation may change only partly with the advent of efficiency-seeking and asset-augmenting FDI. In those cases, lower incomes are no more a major handicap. Efficiency-seeking FDI brings back comparative advantages, and in comparative advantages, countries with lower productivity in all industries still have a role to play, on condition that they specialize on activities in which their disadvantage is smaller, and exchange rates do not eliminate those advantages. The only inconvenience of this situation for lower-income countries is the fact that until catching-up is not robust enough, most of the benefits of the international division of labour are enjoyed in the higher-income countries. As for asset-augmenting FDI, it depends on a single factor: i.e. the availability of unique knowledge. Let us assume, in variance to conservative conventional wisdom, that such knowledge, even if to a lesser degree, can also be derived from less affluent countries (unless we assume that those societies think less than rich societies). This paradox can be explained only if we consider that there are various non-economic obstacles within the EU slowing down the shift of FDI to new member countries. The subsequent section will look at some of them.

Relocation and its obstacles

This section starts from the hypothesis that investment creation does not take place within Europe because it has low social and political acceptance. Conversely, investment diversion, when either restructuring is blocked, or takes place at the expense of more efficient locations (especially outside the EU) may be more socially acceptable, at least in the EU-15. Perhaps it would be too naive to believe that high-income societies would welcome the advent of new types of FDI, and the concomitant rise of lower-income locations in the division of labour created by FDI with open minds. They react to apparent or real losses of activities with protectionism. In some cases, this protectionism is direct; in other cases, it is hidden behind arguments about social dumping from the part of lower-income countries. This situation can explain partly why the enlargement of the EU has not yet succeeded so far with erasing some of the EU-15 countries' economic sclerosis. It is also one of the causes of social unrest in new EU members like Hungary, where people expected more job and welfare creation from EU membership.

This discussion below will use the case study of relocations affecting Hungary as an illustration of these points. The reading of this case study would suggest that we should shed a good part of the current highly politicized EU debate on relocation, which tends to present a simplified and somewhat distorted view of a complex issue. In Western European public opinion, it has become a commonplace assertion that CEE is attracting away FDI from the "old" members of the EU. A reading of the press would deliver the message that relocation is huge (for examples, see Lütge, 2004, April 22; Fockenbrock et al., 2004, March 21; Stürmlinger, 2004, March 10; Der Standard, 2004, April 1; Martinez de Rituerto, 2004, March 28; Jacob, 2004, May 18; Director, 2003, May). As a result, firms envisaging an expansion to the new member countries could potentially face an informal pressure of the public opinion, trade unions and political leaders in the "old" EU member countries.

Reality is far more complex. The location of FDI projects is not a simple win/lose game. Locations not chosen for a given activity still can have major business links with the new project (and thus create additional jobs). Another important consideration is that reorganization itself is a two-way street: projects can be relocated from new EU member countries to older EU members, too, if the latter offer better agglomeration advantages. In the case of Hungary, for instance, in 2004 (the year of EU accession), the output of manufacturing increased by a respectable 9.4% compared to 2003. Within manufacturing, the production of electrical and optical equipment (representing more than 30% of manufacturing) rose the fastest, by 24.2%, reflecting the cost advantages of Hungary. The output of another key industry, transport equipment (representing more than one seventh of manufacturing) grew by an acceptable 8.7%. In turn, the reorganization of production in the aftermath of the elimination of trade barriers resulted in a decline of 3.5% in food, beverages and tobacco production (Hungarian Statistical Office, 2005, February 16).

Before turning to that mini-case study, we have to recall the definition of relocation: it should be of significant size, it should result in concrete transfers of jobs from one intra-region location to another, and it should not be confused with new greenfield projects coming from the outside world. For instance, in the automobile industry, the most important new projects have chosen new EU member countries (Toyota/PSA in the Czech Republic, PSA in Slovakia, Hyundai/KIA in Slovakia) without any relocation. Naturally, EU enlargement was a pre-condition for considering those countries, but Western Europe was not even listed/short-listed for the projects. Previous studies have found very limited relocations so far. Petr Pavlínek (2004, 53) has found three cases of relocation targeting the Czech Republic, which affected about 2,600 jobs. Another study using the example of Hungary (Kalotay, 2004: 41-43) has found nine cases of relocation affecting about 3,400 jobs. These are very small numbers compared to the size of the Czech and Hungarian labour markets, and even more so if compared to the Western European labour market. A careful reading of the numbers

used in the *délocalisation* literature confirms that the size of economic activities to new member countries is, and will, remain limited. For example, a recent headline on 202,000 services jobs to be lost in France in 2006-2010 turns out to include estimates for non-relocated, brand-new projects selecting countries other than France. “80% of these losses are explained by the location of new activities in other countries, rather than relocation in the strict sense”, admits the article (Fay, 2005, April 20; translated from the French original). As a result, there remain only 8,000 services jobs per year that may be potentially relocated, and it is not specified if such relocation will benefit new members within the EU or other continents.

Applying the methodology of the previous Hungarian study (Kalotay, 2004) to a newer period (2004-March 2006), one can derive similar conclusions (table 4). Relocation is a small and really two-way phenomenon. It is particularly true if one considers the cases of downsizings at Flextronics (-950) and TDK (-107) in 2006 that took place in Hungary without relocation. A surprising consequence of the two-way street is that, although the most typical case is when Hungary “wins” at the expense of an EU-15 country, there are also cases to the contrary. It also seems that most of the cases of efficiency enhancing. The cases of tariff jumping (return from China) are rare. Moreover, the phenomenon of relocation is very much industry specific. One can expect a continued trend of Hungary winning in areas such as business services (especially logistics and R&D), automotive (especially in supplier industries) and parts of electronics. In turn, electronics assembly may be expected to “suffer”, as well as textile, garment and footwear, and food, beverages and tobacco. Relocation is indeed a focal point for the EU-25’s internal contradictions. Intra-EU relocation is supposed to be in the majority of cases efficiency enhancing and thus investment creating (or reorganization type). However, it is the type of activities that meets the largest social and political resistance, putting an informal pressure on companies trying to do it.

Table 4 Selected cases of relocation in Hungary, 2004-March 2006

Foreign affiliate	Industry	Effect on Hungary	Other location involved	Estimated employment impact in Hungary
2004				
Alto	Machinery	+	Germany	70
Balda	Plastic	+	Germany	80
Benetton	Garment	+	Slovakia	100
Brooks Instruments	Machinery	+	Netherlands	40
Haldex	Automotive supplier	+	Mexico, United Kingdom	140
Högl	Footwear	+	Austria	23
Knaus	Automotive	+	Portugal	50
Kraft Foods	Food & beverages	-	Austria and Slovakia	-320
Levi Strauss	Garment	+	Spain	n.a.
Märklin	Toy production	+	Germany	100
Nestlé	Food & beverages	-	Czech Republic	n.a.
Nissin Foods	Food & beverages	+	Netherlands	65
Samas	Furniture	+	Germany	50
Schefenacker	Automotive supplier	+	Germany	100
Valeant	Pharmaceutical	-	Poland	-140
2005				
Artesyn	Electronics	-	Romania	-370
Avis Europe	Business services	+	Western Europe	135
Calida	Garment	+	Switzerland	n.a.
Chinoïn (Sanofi-Aventis)	Pharmaceutical	+	France	n.a.
Delphi-Packard	Automotive supplier	+	Austria	16
EDS	Business services	+	Western Europe, United States	400
Heschung	Footwear	+	France	30
Hitiag Leinen	Textile	+	Austria	90
Le Bélier	Metallurgy	+	Western Europe	n.a.
Marsh	Insurance	+	United Kingdom	12
Maxtor	Electronics	+	Ireland	24
Mayr-Melnhof	Packaging	-	Austria, Germany	-50
Robust Plastik	Electronics	+	China	n.a.
Tchibo	Food & beverages	-	Austria, Germany	-43
Triumph	Garment	-	Romania	-105
2006				
Unilever	Food & beverages	-	Czech Republic, Poland, Germany	-200

Source: Author's collection, also data courtesy of Magdolna Sass.

From the Hungarian case presented here, and from the literature, one can draw preliminary conclusions on the patterns of relocation of Europe:

- Relocation is small within the EU-25, and is part of the micro-level impacts.

- Towards outside EU relocation can be large, but mostly unaffected by EU enlargement (except the case of cheaper sourcing of inputs from new EU members as a factor slowing it down).
- From third countries towards EU countries relocation is very small; and is mostly investment diversion (tariff jumping).

New EU members in a potential Pan-European division of labour

EU enlargement offers opportunities and creates challenges for firms already established in the EU or planning to enter the area. TNCs have to adapt their strategies to the new regulatory environment of location Europe (Akbar, 2003). The opportunities and challenges follow the standard impact (expansion, reorganization and rationalization) of integration (Barrell & Pain, 1997). But given the *ampleur* of EU enlargement and the degree of differences between old and new members, the element of uncertainty in predicting the full impact is large.

One also needs to differentiate between incumbent firms (locally and foreign owned alike) already operating in any of the EU-25 countries, and newcomers planning to establish themselves in the EU. Firms planning a major expansion of activities, too, show characteristics similar to newcomers. In the incumbent group, the expansion of the customs union is expected to lead to a gradual and continued reorganization and consolidation of activities. In this process, any location in the EU-25 is a potential winner or loser, independently of the fact that it is in an "old" or new member country. For newcomers, in turn, the main issue is where to locate their facilities. As explained above, in this respect the new member countries offer, for the time being, major cost and productivity advantages. Therefore, firms from outside the EU are likely to locate increasingly their efficiency- and EU-market-seeking new FDI in new EU member countries (Hunya, 2000, 23-24). For them, the considerations of sunk costs and home country pressure may be less relevant. They can imitate the strategy of such firms as Flextronics (Singapore) that have started using new EU member countries as an export platform replicating the global strategy of production experimented in locations such as China on a regional scale (Kalotay, 2002, 1044; Goodman, 2004, December 14).

The opportunities and challenges also depend on the motivations for investment. For market seeking investors (table 5), the enlargement of the EU area provides an important opportunity to increase sales and do more business, especially in the longer term, when the purchasing power and income of new members start to increase significantly (Akbar, 2003). However, in the immediate future, restructuring and reorganization, prompted by fiercer competition in the wake of disappearing trade barrier may be a dominant force in those manufacturing industries and tradable services industries (Dyker, 2001, 1004).

Table 5 Examples of expansion strategies of TNCs in new EU member countries, 2002-2004.

	Market-seeking (national or regional)	Efficiency-seeking (export-platform)	Strategic-asset- seeking strategy
Sector	strategy	strategy	
Manufacturing	<i>Automotive:</i> Poland (in part).	<i>Apparel:</i> Estonia, Latvia, Lithuania.	
	<i>Building materials:</i> Poland, Hungary, Slovakia.	<i>Automotive:</i> Czech Republic, Hungary, Slovakia, Poland (in part).	
	<i>Chemicals:</i> Czech Republic, Poland.	<i>Electronics:</i> Czech Republic, Hungary, Slovakia.	
	<i>Food, beverages and tobacco:</i> Poland, Slovakia, Slovenia, Latvia, Estonia.	<i>Machinery:</i> Czech Republic, Slovakia.	
	<i>Metallurgy:</i> Poland.	<i>Pharmaceuticals:</i> Poland, Slovenia.	
	<i>Paper and packaging:</i> Poland.	<i>Wood and furniture:</i> Estonia, Latvia.	
	Services <i>Financial services:</i> All but Slovenia.	<i>Logistics:</i> Hungary, Poland.	<i>IT:</i> Hungary, Poland, Czech Republic.
	<i>Retail trade:</i> Hungary, Hungary, Poland, Czech Republic, Latvia.	<i>Shared services and call centres:</i> Czech Republic, Hungary, Poland.	<i>R&D:</i> Czech Republic, Hungary, Poland.
	<i>Telecommunications:</i> All but Slovenia.		
	<i>Utilities:</i> Hungary, Czech Republic, Slovakia.		

Source: Author's collection.

For efficiency-seeking investors, for example in the automotive and electronics industries or, more recently, in the shared-services and call-centres industries (table 5), more competitiveness is the main benefit of EU enlargement, at least in the short and medium term. For the time being, they are likely to stop expanding in old EU members and continue to grow in new EU countries. However, they may increasingly realize that new EU members are no longer the right location for activities based on cheap unskilled labour (Hunya, 2000, 21). Those activities may be expected to move either to the new frontier of the EU (South-East Europe and the CIS), or to South-East Asia. Indeed, as highlighted in the Hungarian case above, new EU members have already suffered from some cases of relocation to cheaper, mostly Asian, locations. It also remains to be confirmed to what degree the

productivity advantage of new EU members will be preserved after the entry of these countries into the Euro zone. Strategic-asset-seeking FDI is still in a nascent stage in new EU member countries. It is taking place mostly in information technologies (IT) and R&D, and in three countries: the Czech Republic, Hungary and Poland (table 5). In these areas, competitiveness offered by new EU members seems to be significant in the longer term, especially if they succeed in catching up with the science, technology and innovation capacities of old members. The challenge is how to do it as quickly as possible. In the area of knowledge-based services, the laggard status of new EU member countries is evident not just in comparison with the locations in the Asia and Pacific (such as India and China) that are the global magnets of such activities but also in comparison with the EU-15 and North America. One of the reasons, as mentioned above, is the very nature of those activities, which do not require large investment to be able to provide services (such as for example infrastructure services). While the number of cases has been rather limited so far, the experience of those firms that located business services in new EU member countries has been positive. Potentially, the arrival of knowledge-based services, first to Budapest, and to Prague, both in 2002, is the most marked change of FDI patterns in middle-income accession countries. The move to FDI based on higher labour skills makes the EU accession countries direct competitors with other emerging locations and older EU members simultaneously. Strategic-asset-seeking FDI is nevertheless potentially important for development because of its indirect contribution to host countries' economic structures. Knowledge-based services serve as inputs to other activities they indirectly affect the efficiency and competitiveness of the whole economy. Additionally, FDI in those services enables the transfer of more advanced managerial, marketing and organizational skills and expertise, which have been so far deficient in the new EU members. R&D, which is perhaps the oldest form of services going offshore, when allied to manufacturing, can not only help improve the product but can also generate new spillover effects. As a result, it pays to encourage overseas firms to engage in R&D and network it with local private and public research institutions. The networks could enhance human capital and knowledge, which is an essential input into the development process. It is also necessary to enhance the teamwork and managerial skills of talented work force for them to undertake team-based projects at home.

If adjustment to EU membership is successful, it will affect FDI all over the European continent. All new member/accession countries but Bulgaria and Romania are upper-middle-income or high-income (Slovenia) countries. All South-East European and CIS countries but Croatia are lower-middle-income countries. This may lead to an increase in FDI in services and higher corporate functions in accession countries, in part attracted from current EU members and third countries. EU enlargement offers opportunities to South-East European and CIS countries, because assembly-type manufacturing may shift to them from higher cost accession countries. New EU member countries may become major sources of skill-intensive assets, combining their advanced education with competitive production costs. In this integrating European continent, market size and market growth will increasingly denote the enlarged EU as a whole, providing benefits mostly to new member countries, particularly those with limited domestic purchasing power.

Conclusions

Policy-oriented conclusions from the above cases of restructuring and relocation could use the EU's aim to become the "the most competitive and dynamic knowledge-driven economy by 2010" (Lisbon Strategy, 2000) as a starting point and a benchmark. So far, the EU has seemed to go to the opposite direction – it is enough to cite the EU's shrinking share in global R&D, in sharp contrast with the Lisbon goal to increase its share (to 3% of GDP). Nor is it difficult to see progress in the reduction of bureaucratic obstacles to entrepreneurship and increasing employment (to 70% of active population). The above analysis, in particular,

is a reason for caution. For instance, there does not seem to be a coherent policy towards the retraining of the 'losers' of restructuring. In addition, in the social, cultural and political field, the EU is very much fragmented and divided. The question is still very open whether a single institution such as the European Commission can overcome the resistance a wide coalition of resistance in powerful member countries. And if politics stop the integration process, it remains an open question whether the still advancing economic integration alone would survive that.

In the changing world of FDI within the enlarged EU, national and community-level policies dealing with the consequences of restructuring matter. They matter first and foremost because whatever seems to be marginal at the macro level may become an issue for micro, local levels. For instance, the small group of people who eventually lose or face uncertainty because of restructuring consists of individuals who are important as citizens and voters. There are also special social groups such as unskilled people in developed countries who became particularly vulnerable due to the replace ability of the jobs in lower cost locations. In general, losers need to be looked after in order to avoid political and social problems, which can take many forms such as social unrest in various parts of Western Europe, outbursts of violence, or massive protest votes in political affairs such as the unpleasant surprise of negative votes on the EU constitution in referendums, leading to a potential stalling of the integration process of the EU.

To deal with issues related with restructuring, all EU members need effective social and labour market policies adapted to both intra-EU and global competition. In both areas countries need to cooperate with each other, although at different levels. In the former case, the issue is to create win-win situations for countries that seem to engage in irreconcilable competition between each other. In the case of the latter, the issue is to establish rules that enhance the competitiveness of the EU-25, and not just temporarily protect it from outside pressures. In this respect, all countries have weakness in their labour policies. The political instability of the Central European new EU members also gives food for thought for policy makers at the level of the Community who have focused probably too much on the issue of how to mitigate the impact of relocations in old member countries, and less on the question of how to create, and what kind of, jobs, in new EU members. That resulted in probably unrealistic expectations in these new member countries about the amount of jobs available and their remuneration. The ambiguity of policies about division of labour and salaries may have contributed the false impression that the attraction of highest-value added jobs at high wages was imminent. This sentiment then became the hotbed of populist messages demanding "European wages" by *fiat*. If political tensions cool down, a long and sobering debate awaits Central Europeans on the prospects of jobs and wages, far from the exaggerated illusions of 2004-2006, but closer to the realities of pan-European division of labour.

Policies are also important because they can make sure that all countries benefit from the advantages of intra-division of labour, while the costs are looked after correctly. In a broader perspective, a new division of labour between the three Europes – the "old" EU, the new EU and other "Central and Eastern Europe" – is more likely to emerge than competition for the same investment projects or, for that matter, massive relocation. This emerging division of labour across the integrating European continent improves the efficiency of operations in Europe as a whole.

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Public governance institutions and their impact on delocalisation of labour intensive industries with evidences from Estonia

Kaarel Kilvits¹⁵

Tallinn University of Technology

Alari Purju¹⁶

Estonian Business School
Tallinn University of Technology

Abstract

The transfer by multinational companies of production from one country to another has become an important issue in different sectors of economy. The impact of policies applied by EU new member states and adjustment mechanisms used by participants in this process are the main problems discussed in this paper. The policies have been applied in different fields like industrial policy, innovation policy, foreign direct investments (FDI), labour relations, support to clusters, support to local companies to improve position in value chain. The role of multinational enterprises (MNE) and their relationships with different level governing institutions is another important factor. The critical areas where economic interests of MNE-s and policy goals of governing institutions meet are the labour market regulations, the FDI related problems, conditions for foreign trade, innovation, taxation and state aid. Subcontracting, outsourcing, off-shoring and offshore outsourcing, value chain and clusters are the specific concepts what describe forms in which organisational and technological capacities have been matched together. One task of current paper has been to clarify those concepts and describe policies and regulations applied in Estonia. The examples used in the paper are from electronics and garment industries.

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¹⁵ 101 Kopli Str., 11712 Tallinn, Estonia E-mail: kilvits@tv.ttu.ee

¹⁶ 3 Lauteri Str., 10114 Tallinn, Estonia E-mail: alari.purju@ebs.ee; 101 Kopli Str., 11712 Tallinn, Estonia E-mail: purju@tv.ttu.ee

Introduction

The following paper seeks to cover public governance problems and opportunities related to delocalisation problems of labour incentive industries. The public governance issues are treated at the EU, national, local and sector levels. The main goal of this paper is to summarise the objectives and experiences of policies applied by different agents.

The role of multinational companies and their relationships with different level governing institutions is another important factor. The critical areas where economic interests of MNEs and policy goals of governments meet, are the labor market regulations, FDI related problems, innovation.

The EU membership of Estonia from 2004 brought on the EU level discussion of the issues. The earlier screening and harmonization procedures necessary for the EU membership framed requirements for regulatory tools to deal with these issues. At the same time, the exact content of these tools has been still substantially determined by national governments. The change of position of particular industries in the delocalization process is an important stimulus to work with policy tools.

Estonia has been dominantly a target place for new investments from developed countries. The increasing labor and other costs, however, are changing the situation at least for some industries, which saw outsourcing of important part of production activities to countries with even lower costs. The adjustment mechanisms so give interesting evidence from different aspects of those developments.

The paper covers important concepts describing delocalization process, the impact of industrial policy, labor market relations, FDI. The examples are from electronics and garment industries.

Definitions

Governance is generally understood as a broad process affecting the collective decision-making roles and procedures, management and authority relationships of social and economic agents involving multiple jurisdictions and domains. Governance is about governing and therefore cannot be isolated from political responsibility in all areas in which delegated authority makes decisions.

There are several definitions of governance. Daniel Kauffman of the World Bank describes governance as “the exercise of authority through formal and informal traditions and institutions for the common good” (Kaufmann, 2003). UNCTAD refers to “the way in which the main players in the society, governments, business and civil society work together to make the society better” (UNSTAD, 2003). The EU body gives the following definition: “The term governance, in corporate and State contexts, embraces executive bodies, assemblies (e.g. national parliaments) and judicial bodies (e.g. national courts and tribunals). The term governance corresponds to the so-called post-modern form of economic and political organisations (European Union, 2005a)”.

The main tools of governance are institutions creating rules of the game and enforcement means putting those rules to work. The governance is a very important factor in determining the value of human and social capital. The governance is realised on different levels and in different policy areas. In our study, the governance aspects related to delocalisation problems of labour incentive industries are under consideration. Within the framework of our approach it is assumed that different policies at different levels could be supportive to each other or there could be also contradictions and negative side effects of different policies on

each other. For example, innovation activities at regional and national levels could support each other. On the other hand, there are several evidences that innovation policy measures and labour policy measures could produce mixed results and not support each other. One task of the current study is to analyse the problems emerging from parallel application of policy tools targeted at governance at different areas and to propose more useful policy mixes.

Internationalisation and governance

Political, economic and technological processes are integrated in the world. The process called globalisation is linking more and more areas, activities and persons into the process of development. Those trends are related to change of values, ideologies, income levels and consumption patterns. For our study, the increasing trade, capital mobility and widespread diffusion of technology are the most influential factors of interdependence of countries, which is the basis for economic side of globalisation. Studies of different problems of internationalisation and globalisation of entrepreneurship have acquired an increasing importance (Bollinger et al., 1993; Commission of..., 2001, 2003a, 2003b; Storey and Tether, 1998; McDougall and Oviatt, 2000; Doing Business ..., 2004; World Development Report 2005..., 2004).

The role of multinational enterprises creating spillover effects between private enterprises located within or outside the national borders is becoming increasingly significant. Alongside with transfers of technology inside large trans-national enterprises (TNE), adaptation to legal framework, to cultural differences are important factors that determine success of internationalisation (Johansson and Vahlne, 1977, 1990; La Porta et al., 1998 and 1999, Djankov et al., 2002; Glaeser and Shleifer, 2002).

Such spatial phenomenon as geographical proximity has been considered important (Krugman, 1991). Agglomeration effects, related to territorial concentration of capital, are influential in determination of internationalisation path (Fujita et al., 1999; Krugman, 1991, 1995). There is a certain role for governments in bringing about agglomeration. Similarity of institutions is considered to be very significant (North 1990, Aoki, 2001). Scholars have emphasised the substantial management costs for a firm when expanding from its home country system to another, less familiar environment. The market entry choices of the internationalising firm reflect a desire to avoid where possible any added complexity and additional costs related to novel institutional environment. One possible way of adaptation is to focus on those countries where legal system is the same as in the firm's own country. Several authors have described the ways of adaptation to those additional problems.

Oxley (1999) has showed empirically that firms adopt more hierarchical governance modes when the institutional environment weakly protects exchanges. Coeurderoy and Murray (2005) proved that new technology based firms in service sector enter countries with different legal environment later in their internationalisation process than high technology firms in manufacturing industries. That is because in sectors that are dependent on highly codified and formalised information, for example high-tech hardware manufacturers, limited access to local technical knowledge is likely to influence less the firms' foreign market entry decisions. Over time, the market acceptance of "best practice" manufacturing system is likely to be universal and not country specific. Conversely, for a service sector firm exploiting more tacit and idiosyncratic forms of knowledge, the locality in which that information is either applied or sourced would influence the value of that knowledge. This constraint inhibits the inception or scale of internationalisation of service companies.

The EU level¹⁷

Discussion about the role of EU

The EU represents an intergovernmental organisation with tendencies toward deeper integration in the federal form. In this sense, the EU is different in comparison with regional organisations, which have concentrated their efforts first of all on creation of free trade area without deeper integration efforts in other fields of policy making.

In discussion about the future governance models of the EU, two wide sets of problems have been brought out. The first one is related to overlapping jurisdictions and another concerns a principal choice between dirigisme and rhetoric versus laissez-faire¹⁸.

In the case of dealing with problems of delocalisation of labour, both sets of problems are important. The overlapping jurisdictions and regulations issues concern the impact of regulations in the field of social protection and labour market issues on the EU level and division of responsibilities between the EU institutions and national governments. The role of increasing EU legislation in social areas and national governments' choices between economic policy models is one example.¹⁹

It is possible to argue that those general problems are important while dealing with different governance problems of the delocalisation. Those general approaches biased toward more market based or more intervention based policies determine also scale and scope of measures applied at the EU level and influence through harmonisation efforts national policies.

¹⁷ The EU could be treated as a regional intergovernmental organisation. Such organizations are a possible response of nations to the process of globalisation. First, they are a "platform" established to enable an active participation of member states' economies in the global world. Secondly, they spread out a "safety net" against the threats coming from a turbulent intensification of the international exchange. Other examples are *North American Free Trade Area (NAFTA)*, the objectives of which are elimination of barriers to trade in, and facilitate the cross-border movement of goods and services between the territories of the Parties, promotion of conditions of fair competition in the free trade area, increase substantially investment opportunities in the territories of the parties; provision of adequate and effective protection and enforcement of intellectual property in each Party's territory, creation of effective procedures for the implementation and application of the Agreement for its joint administration and for the resolution disputes; establishment of a framework for further trilateral, regional and multilateral cooperation to expand and enhance the benefits of this Agreements. See, NAFTA (2005); *Association of South East Asia Nations (ASEAN)* with the objectives: 1) to accelerate economic growth, social progress and cultural development in the region through joint endeavours in the spirit of equality and partnership in order to strengthen the foundation for a prosperous and peaceful community of Southeast Asian nations; 2) to promote regional peace and stability through abiding respect for justice and the rule of law in the relationship among countries in the region and adherence to the principles of the United Nations Charter. See, ASEAN (2005).

¹⁸ The problem of overlapping jurisdictions is connected to confusion about the allocation of powers between the Commission (the super-national body) and the Council (the quintessential intergovernmental body). Other side of the same problem is related to confusion about the role of EU institutions and national competences. The theoretical literature of federalism provides a clear principle of allocation of responsibilities between national governments of the EU: the latter should engage in those policy areas where economies of scale and externalities are large and heterogeneity of preferences amongst different countries is low. The second problem is the clash between dirigisme and laissez-faire. A dirigist and regulatory approach to the economy, with the heavy emphasis on "coordination" and "plans" has had so far a relatively limited impact, because the powers of EU institutions in many policy areas are still limited. ...The Constitution has tried to solve the first problem with mixed results. The second problem has to do with the "culture" and vision about the role of government. In this respect the Constitution adds problems....These views should not be taken as saying that the European integration project is intrinsically wrong. On the contrary, there are many benefits from internalising externalities and economies of scale that can be gained with a supernational structure. In fact, those areas where the two problems have been avoided have been a success for Europe....One is the European Central Bank and the common monetary policy... The second example is single market and competition policy. See, Alesina and Perotti (2004).

¹⁹ For example, there is documented a large increase of EU legislation in areas such as welfare and citizen protection that are quite far from the original mandate of EU institutions. See, Berglöf, et al. (2003).

Documents on governance

The European Commission established its own concept of governance in the White Paper of European Convergence (COM (2001) 428 final, 25 July 2001) and in the Council conclusions of May 2002. The White Paper describes how the Union uses the powers given to it by its citizens. In addition, the Commission has published a number of communications and strategic documents on the governance theme over recent years (for example, Communication on EU neighbourhood policies ("Wider Europe", COM (2003) 104 final, 11 March 2003) and Communication on human rights in the Mediterranean region (COM (2003) 294 final, 21 May 2003). In these documents the term "European governance" refers to the rules, processes and behaviour that affect the way in which powers are exercised at the European level, particularly as regards openness, participation, accountability, effectiveness and coherence. These five "principles of good governance" reinforce those of subsidiarity and proportionality (European Union, 2005d).

In October 2003, the Commission adopted a Communication on governance and development (COM (2003) 615), which sets out a new, more pragmatic vision of countries' effectiveness in eradicating poverty and promoting sustainable development in the world.

On the basis of lessons learned from the governance approaches adopted by the Commission and other donors, and taking account of these views of partner countries and their own experiences, the Commission Communication aims at identifying practical ways of governance.²⁰

This will be the means by which the Commission will guide the EU's approach to governance and development, identify the type of measures to be supported in different situations, and contribute to the international debate on these issues. A handbook will help translate this policy approach into practical cooperation.

The debate on European governance, launched by the Commission in its White Paper of July 2001, concerns all the rules, procedures and practices affecting how powers are exercised within the European Union. The aim is to adopt new forms of governance that will bring the Union closer to European citizens, make it more effective, reinforce democracy in Europe and consolidate the legitimacy of the institutions.

Industrial policy

The general principles of EU industrial policy date from the Communication "Industrial policy in an open and competitive environment: guidelines for a community approach" of October 1990 (Commission of the European Communities, 1990). Its instruments, which are initiatives, exploit their ideas and build on their opportunities. Three key factors of industrial competitiveness deserve particular attention: knowledge, innovation and entrepreneurship.

In December 2002, the Commission published its Communication on "Industrial policy in an enlarged Europe" to launch the debate on industrial policy (Commission of the European Communities, 2002). In order to address current fears about de-industrialisation, the European Council in October 2003 asked the Commission to assess the situation and to

²⁰ The principles of governance are related to following targets: building capacity for governance and increasing partner countries' input into formulation of the relevant reform programmes; ensuring synergy and consistency between the various Commission and EU instruments and policies; reinforcing development partnerships on a regional basis with a view to achieving coordination between donors' priorities and partner countries' agendas by way of policy dialogue, as well as complementarity between fund providers; contribution to protection of human rights and spreading democracy, good governance and the rule of law. See, European Union (2005d).

present solutions to counteract this trend in order to revive Lisbon strategy of making the EU the most competitive economy in the world by 2010.

Industry leaders and politicians have voiced their fears about the EU's manufacturing base moving out of Europe to benefit from cheaper labour, lower social costs and more flexible regulation in the East. The Commission on 20 April 2004 published new Communication "Fostering Structural Change: an Industrial Policy for an Enlarged Europe", which examines the competitiveness of European industry, assesses the existence and scale of the risk of de-industrialisation and proposes specific solutions (Commission of the European Communities, 2004).

The Commission recognises that the EU is facing a process of structural change at various levels, but points that "the ongoing process of resource allocation from manufacturing industry to service should not be confused with a process of de-industrialisation. In order to support the process of structural change in the EU, the Commission has outlined a set of specific measures, which cover regulatory framework, community policy and combines sector level policies".²¹

The Commission will continue to examine the competitiveness of specific sectors each year and launch initiatives as necessary. For 2004 and 2005, initiatives are planned for the following activities: 1) an initiative in the mechanical engineering sector; 2) an analysis of the eco-industries sector with a view to taking certain measures; 3) the creation of a high-level group in the automobile sector; 4) study of the non-ferrous metals and the IT sector (Commission of the European Communities, 2004).

Most of the industrial policies are not carried out at EU level, but under the competence of the Member States. The open method of co-ordination, set up by the Lisbon European Council, offers a context in which national policy performance can be discussed, developed and improved.

One important question related to delocalisation issues is whether the European countries should implement policy measures to fight de-industrialisation, i.e. the decline of production industries both as a share of total output and in terms of employment levels? Mathieu and Sterdyniak described three possible general approaches to that issue: 1) de-industrialisation is a natural phenomenon and should not be opposed; 2) policy means should be targeted to important structural supply side issues like R&D, education and factors related to general competitiveness of economic environment like tax policy, burden related to welfare state; 3) the traditional view that specific support should be implemented in favour of unskilled labour, because their loss of jobs and increase of unemployment for that reason should not be tolerated (Mathieu and Sterdyniak, 2005).

Every approach requires different policies and roles of public governance agencies. Seemingly the process needs state intervention, but bias toward one or another approach would be determined by future developments and depends on industrial structure and development level of particular country. To find out interrelationships between policy bias and required public governance structures to realise it, is one task of the current research

²¹ Regulatory framework arguments support an idea that burdens on industry must be reduced to the bare minimum of what is strictly necessary to achieve objectives of regulation and a balance must be struck between industrial competitiveness and the need for regulation. Community policies arguments stress, that synergies must be better exploited to improve the policies' impact on industrial competitiveness. The focus should be on developing a knowledge-based economy and strengthening cohesion in an enlarged EU. Combination of policies at sector level means that the EU must continue to develop the sector dimension of industrial policy while ensuring that its sector policies are strengthening industrial competitiveness. See, Commission of the European Communities (2004).

The Commission estimates that EU enlargement presents unique opportunities to European business. Value chains can be reorganised across the continent to benefit from the current competitive advantages of the new Member States. This may enable companies to keep production within the EU that would otherwise have been transferred to Asia, and maintain their competitiveness.

Experts are divided over the impact of de-industrialisation on European competitiveness and employment. While many, including the employer organisation UNICE, underline the fact that the trend destroys jobs and value creation in Europe, others consider de-industrialisation a necessary evil to maintain the competitiveness of the EU's industrial base. Through outsourcing, goes the argument, companies will be able to keep costs down and thus boost growth, which will ultimately benefit and stabilise its European operations (UNICE, 2003, 2004).

Other economists argue that Europe's future is not so much threatened by de-industrialisation as by other aspects of delocalisation, including the migration of R&D activities to US, particularly in the high technology, research-intensive sectors as pharmaceuticals or biotechnology (Fontagne, 2005).

There are three critical questions for research and design of governance tools: 1) Should manufacturers be encouraged not to delocalise? 2) Should there be massive investment in research and development in an effort to maintain a technological edge and what are conditions for that? 3) Is it possible that delocalisation creates massive unemployment and social problems at that critical level that forces the EU to restore barriers to protect European industry? The evidences from industries give some possible answers to those questions.

National level

The state's role in governing structural industrial problems such as delocalization, has been widely discussed in economic literature. In the 1950s and 1960s, aid programs and academic advisors propagated the idea of state bureaucracy as the lead agent for the transition to what was then known as modernization (Stone, 1965). Aid agencies favored large-scale projects of industrial development, which, in their turn, required the guarantee of government involvement (Esman 1988). The state-led development was not only imitative but also built on a response to local circumstances. The case was made in re-structuring the economy towards "inward directed" industrial development on the basis of import substitution (Todaro 1994). Until the mid-1980s, the role of the state expanded, in advanced countries faster than among developing countries. The statist model became subject to criticism. As Batley and Larbi defined, until the full force of the neo-liberalism perspective arose in the 1980s, this was not a matter of ideological opposition to the extension of the state as such. It was rather a question whether the states and public administrations of developing countries were structurally (not just technically) capable as the agent of development (Batley and Larbi 2004: 3).

The immediate roots of the neo-liberal revival lie in the economic crises that followed the rise in oil prices in the early 1970s.²² Many countries were slow to adjust to the new economic order and got themselves into deep difficulties of debt and inflation. They had to resort to the IMF and the World Bank loans, which were linked to certain conditions, the reduction of the role and scale of the public sector. That was accompanied by spread of new liberal view with

²² Batley and Larbi mention that the United Kingdom experienced the first structural adjustment program when in 1976 it negotiated a loan from the IMF. In return it had to accept public expenditure cuts, divestiture of public enterprises, a floating exchange rate and restraints on money supply. These became the principal elements of the structural adjustment programs that were later applied globally. See, Batley and Larbi (2004: 5).

a deeper skepticism about the capacity of state administration to play a developmental role under any circumstances.

That approach was quite important also in transition countries where creation of market economy started in the beginning of 1990s.²³ Partly in response to the experience of liberalization during the 1990s, partly due to impact of Association Agreements and integration with the EU, the institutional side of reforms started to be more important. The goals of reforms were extended from freeing market forces and making economies efficient to addressing problems related to institutions like clear property rights, the rule of law, financial systems, accountability of government, effective and efficient public administration (Kohsaka 2004; Rodrik 2004).

In general approach to government roles, we can use division to indirect and direct roles described in economic literature. The indirect roles concern policy and rule making, enforcing and upholding law, maintaining competitive conditions, providing information. The direct roles are related to managing and provision of service delivery through different government agencies (Batley and Larbi 2004: 17).

Employment

There is a large number of economic literature on labor market problems of the EU (Blanchard 2004; Boeri 2000; Boeri and Terrell 2002; Svejnar 2004). Blanchard presents the made-up quote that is a fair presentation of the opinion of many experts and many organizations and states over-regulation of the labor market.²⁴ In our approach we will concentrate on worker-firm relations and will not treat wider set of aspects related to other labor market issues.

Governments intervene in worker-firm relations on three main fronts: they intervene in the wage-setting process, they regulate working conditions and they control firing and hiring of workers. The government commonly regulates work hours and the cost of overtime; mandates vacations, holidays and sick leave; sets minimum wages; restricts child and forced labor; ensures non-discrimination; provides unemployment, disability and retirement income insurance, and in many countries health insurance, and sets and conditions for hiring and firing, unionization and collective bargaining ("European Union" 2005b; OECD 2003; World Bank 2004)

These interventions are theoretically justified by the ability of pure market conditions to deliver efficient and equitable outcome. At the same time, the government interventions need to strike a balance between several interests. There are tensions not only between the interests of firms and workers. Workers in the informal economy and the unemployed can have very different interests from those currently employed in the formal economy. There could be very special interests of particular lobby groups.

The World Bank study shows that from an investment climate perspective, labor regulations can be a major or severe constraint on firm operations in many developing countries.

²³ In transition economies like Estonia, there was a very limited expertise in market economy for a number of spheres of economic policy early in the 1990s. The role of international organisations was for that reason extremely important in formulating principles of legislation, regulations and in making general economic policy choices. Their representatives often preferred solutions that were not influenced by local lobbies but based on market solutions.

²⁴ Western Europe suffers from too many labor market rigidities, from excessively generous unemployment insurance, high employment protection, and high minimum wages. It is essential that countries putting in place new institutions do not make the same mistakes. See, Blanchard (2004: 129). However, Blanchard himself is more sceptical, saying that labor markets are far from textbook competitive markets and do not function well without proper institutions. And these institutions came into being in response to clear market failures...That... does not imply that the institutions we have today are optimal in any sense. ...Still, it is clear that simple slogans will not do. Economists owe countries in transition clear analysis of what institutions are needed today, how they should be designed and how existing institutions should be reformed (Cit.op.).

Regulations can reduce incentives to make new investments, adjust the organization of work to take advantage of new technologies or opportunities, or hire more workers. Some curtailment of those incentives can be justified by social goals beyond those reflected in the core labor standards including, for example, the promotion of workplace safety. But ill-conceived approaches can exacerbate poverty by contributing to unemployment and swelling the size of informal and unprotected economy.... Governments need to confront these difficult and often sensitive tradeoffs (World Bank 2004: 141-142).

Increased economic integration and free movement of labor has a strong impact on domestic labor markets. In the case of Estonia, highly skilled and reasonably priced labor has been one of the cornerstones of rapid economic growth. The relatively flexible labor market contributed positively to changes in the structure of economy.²⁵ During last couple of years and especially after joining the EU in May 2004, migration became a significant economic and social policy issue in Estonia. One of the main incentives for migration is the existence of an income cap between the home country and destination countries, first of all Scandinavian countries, but also Ireland and United Kingdom. The latter two are the EU countries not applying a transition period for labor market opening for the other EU members.

Many investors in Estonia are still interested in the maintenance of low technology, cheap labor requiring jobs and even creating of the new ones. At the same time, many low-paid workers move away from Estonia to earn much higher wages for analogous work in other EU states where also working conditions are better. That has an impact on wage setting in Estonia and creates increasing problems for labor-intensive industries in Estonia. The hardest hit are subcontracting enterprises like wearing apparel, where proportion of labor costs in total costs is up to 80%.

Emigration of labor force launches a chain reaction in the labor market. The jobs of those who left for abroad are filled with workers lured over from other enterprises or with unemployed. When skilled people leave it is necessary to train new people to replace them. This leads to a rise in qualification of employees and reduction in unemployment. Age discrimination will decrease and employment of handicapped people will increase.

International competition from low wage countries makes it impossible to substantially increase wages, which creates problems with finding workers. In Estonia, it has been possible to find low skilled and badly disciplined labor force from peripheral regions and attract them to industrial towns. Such kind of activities, however, would even more aggravate social and regional problems.

Another option is immigration from the third countries that would make it possible to keep the present economic structure and prevent overall socio-economic deterioration. That depends to a large extent on the national policy that has been restrictive until now regarding inflow of foreign labor.

The overall labor market policy on government level is a duty of the Ministry of Social Affairs. The main institutions dealing with conflict resolution are the industrial dispute commissions, the public conciliator as well as local conciliators, and courts. In general, the industrial relations are mainly regulated through minimum standards set at the state level (minimum wage, unemployment benefits, the minimum subsistence level), partially through social dialogue on national level and through individual contracts or enterprise level contracts. The social dialog is realized through tripartite negotiations, where the parts are the government, representatives of employers and employees.

²⁵ Flexibility of labor markets is divided into macro and micro level flexibility. On macro level, institutional and wage setting flexibility are the forms of it. On micro level, flexibility is related to job flows, job creation and destruction. See Blanchard and Jimeno (1995), Layard et al. (1991).

The flexibility of labor markets is closely linked to the trade unions and rules and habits of negotiations concerning labor market regulations.

Trade unions

Trade unions have played an important role in labor relationships in Europe. The main play field has been on nation level. Union coverage started to be lower in service economies in comparison with industry dominated economies. Trade unions in the former Soviet bloc countries have changed from institutions of Communist party controlled and distributors of fringe benefits to becoming representatives of workers' economic interests (Svejnar 2004).

There are powerful organizations on the EU level. The European Trade Union Confederation (ETUC) has called for the activities underpinning competition. Without that, market forces will lead to firms competing on the basis of low quality, low prices and bad and low-paid jobs, says ETUC, blaming industry for using existing problems as an excuse for pushing through a deregulation and the liberalization agenda. ETUC has also called for more emphasis on social protection and sustainable development (ETUC 2005).

Trade unions in EU-15 countries have been worried about the generally low position of trade unions in the new EU countries. The active support and involvement of the ETUC in those countries have been seen as the main task. There are areas like collective contracts, firing conditions and minimal wage where trade unions' role should be compared in different countries.

There are two national trade union confederations in Estonia. The Confederation of Estonian Trade Unions (EAKL) is the largest organization for blue-collar workers, comprising 23 branches and approximately 50,000 members. The Estonian Employees' Unions' Confederation (TALO) is the organization of trade unions of white-collar workers, first of all civil servants in public educational sector. It is estimated that approximately 15% of the labor force belonged to trade unions in Estonia (Eamets and Kallaste 2005).

The low level of membership is accompanied by a low level of collective bargaining coverage. This indicates that there is no higher level binding collective bargaining than the enterprise level (with the exception of transport and health sectors with branch level agreements).

Regarding impact on delocalization issues, the evidences from other countries confirm that possibility to switch the location of production reduces the bargaining power of unions. The possibility of labor migration at the same time increases bargaining power of unions (Calmfors 1993). In Estonia, examples of possible effects have been demonstrated by an earlier study: in health care sector unions have gained additional strength by the possibility for medical personal to move abroad; in the textile sector the unions have lower bargaining power due to the possible relocation of industry (Eamets and Kallaste 2005).

As it is possible to see from those examples there are in force factors supporting and weakening effects of trade union activities. Nevertheless, it is possible to see several additional tasks for trade unions playing bigger role in negotiations, consultation and representation of members in legal issues, also on international level.

FDI

Delocalization with capital contributions, i.e. creation of a subsidiary company or fusion-acquisition is very important. The company acquires a factory in other state and that factory

starts to produce whole or part of its production. The delocalization with capital contributions is the riskiest by far.

Over the past decade, the FDI intensity (defined as the sum of outward and inward FDI positions over GDP) has increased significantly in the European Union. Most of the global FDI takes the form of ownership changes in existing enterprises (mergers and acquisitions, privatization), with so-called “green-field” investments playing only a minor role.

Attracting FDI has become a central component of industrial policy in developed and developing countries. Image, brand awareness, and perceptions are major factors influencing the location of FDI. Companies make investment location decisions on the basis of their information pool and understanding of an area’s location “offer”. Investment promotion is therefore an essential component of attracting investment. There has been a rapid growth in the number of investment promotion agencies (IPA-s) across the world.

It is not enough for individual countries to simply engage in a race to attract foreign investors. Some form of “institutionalized confrontation” between host Governments, supranational Organizations and representatives from the MNEs should be developed.

Investment promotion can be divided into the following areas: 1) strategy and organization (includes setting the national policy context, objectives, structure of investment promotion, competitive positioning, sector targeting strategy); 2) lead activities (marketing; company targeting); 3) facilitation (project handling); 4) investment services (after-care and product improvement; monitoring and evaluation)²⁶.

An investment promotion strategy involves the organized use of a range of promotional activities to enhance the capacity of a country to absorb FDI and thereby to increase level of investment and intensify linkages in a country. Most of the strategies use four different but interrelated sets of activities with varied emphasis depending on changing conditions: 1) activities to service existing, prospective and new investors (involves pre-approval services, approval services and post-approval services to existing, prospective and new investors. The key issue in investor servicing is policy effectiveness in reducing uncertainty for the investor); 2) procedures aimed at identifying and removing administrative obstacles and managerial impediments to the FDI; 3) campaigns to enhance the image of a country (comprises effective communication about the location); 4) actions to generate and increase flow of investor’s projects (involves broad- or narrow-cast targeting as well as direct marketing to individual investors).²⁷

The importance attached to each of these activities varies by country and over time, but at any given time most of the strategies include elements of all four activities. An investment promotion strategy should combine these techniques in innovative ways that suit the economic and industrial development requirements and the resources of an individual country.

Incentives can and do affect investment location decisions. However, the emphasis on incentives varies considerably. Options include national, regional, or local grants, tax credits, research and development and other special purpose incentives, employment incentives, recruitment and training assistance and site or infrastructure improvements. Incentives can be up-front, or dependent on continuous upgrading of the investment project. Many IPAs use their governmental network of overseas foreign offices for overseas promotion. There is also increasing cooperation between agencies.

The general supportive macroeconomic framework with relatively modest tax burden and development of institutions typical for market economies have been a major supportive

²⁶ See, Christodoulou (1996), Dicken (1990), Loewendahl (2001), Young *et al.* (1994).

²⁷ See, for example, analysis and suggestions of international organizations concerning inter-relationships between the FDI and business environment, by *Doing Business 2004...* (2004), OECD (2005), UNIDO (2005), World Bank (2004), WIIW (2005).

argument for the FDI in Estonia. Closeness to Scandinavia, and not only in geographical terms, played also a certain role. Afterwards the EU integration and membership achieved in 2004 gave evidences about increasing maturity of market economy institutions. There were no special treatment of foreign companies since 1994, national treatment of all investors were a significant supportive factor.

Innovation

Innovation development is related to institutions and financial incentives to promote technology transfer. Innovation policy is widening to include support for new firm start-ups, university spin-offs, science and technology incubators and parks and promotion of an innovative, entrepreneurial culture.

Comparative studies on innovation policy recognized that it is not easy to define who is responsible for innovation policy. In many cases, governments attribute innovation to the ministry with responsibility for economic affairs or industry. However, even where there are specific departments of ministries with a remit for innovation and technology policy, they do not play a role in co-coordinating innovation policy matters across ministries. Funding of industrial R&D and innovation is delivered on a sectoral basis (ministries of economic affairs, education, health, transport, regional development etc). The existence of government policy documents or even funding agencies and programs do not guarantee either the availability of government funding for innovation policy initiatives or the effective disbursement of funds ("Innovation policy issues in six candidate countries" 2001:13-16).

Other part of the issue is that comparative research across the countries has extensively reported that a very big proportion of innovations have been made by MNEs and there are important and persistent differences between foreign subsidiaries and domestic firms (Dunning 1993). On those circumstances, it is important to investigate how innovation activities and tools are combined with innovation taking place in MNEs and how much those big companies use research organizations in home countries.²⁸

There is a linkage between FDI, innovation taking place in firms with foreign capital, and employment.

Subcontracting, outsourcing, off-shoring and offshore outsourcing

Delocalization without capital contributions by means of subcontracting is the most widespread form. Subcontracting is defined as the manufacture of goods by one firm (the subcontractor) to another (the lead firm) based on the specification of the latter. Often there can be several layers of firms or intermediaries mediating the relationship between the actual production workers and the end product market. The lead firms normally exercise considerable control over their subcontractors in terms of price, quality and timing of the products they supply.

According to UNCTAD, subcontracting is yet another form of investment, although a non-equity one: "Foreign direct investors may also obtain an effective voice in the management of another business entity through means other than acquiring an equity stake. These are non-equity forms of investment, and they include, *inter alia*, subcontracting, management contracts, turnkey arrangements, franchising, licensing and product-sharing" (UNCTAD 2004: 346).

²⁸ Study on Belgium shows that if there is a competitive and internationally recognized academic community, MNEs finance a big part of research in academic institutions. See, De Backer and Sleuwaegen (2004).

Outsourcing is the delegation of tasks or jobs from internal production to an external entity (such as subcontractor). Most recently, it has come to mean the elimination of native staff to staff overseas where salaries are markedly lower. This is despite the fact that the majority of outsourcing that occurs today still occurs within the country boundaries.

Off-shoring can be defined as relocation of business processes (including production/manufacturing) to a lower cost location, usually overseas. Offshore outsourcing is the practice of hiring an external organization to perform some or all business functions in a country other than the one where the product will be sold or consumed.

Governance of delocalization of labor intensive industries through subcontracting, offshoring and outsourcing is a possible supply chain management (SCM). This is the management of upstream and downstream relationships with suppliers and customers to deliver superior customer value at less cost to the supply chain as a whole.

Value chain

To better understand the activities through which a firm develops a competitive advantage, it is useful to separate the business system into a series of value-generating activities referred to as the value chain (Porter 1990). The primary value chain activities are: inbound logistics, operations, outbound logistics, marketing & sales and service. The primary activities are supported by the infrastructure of the firm, human resource management, technology development and procurement.

Position in the value chain has a major impact on company's profits. Markets are very competitive concerning the low part of value chain. There are less competition and higher profits in upper side of the value chain. Very questionable is the existence of direct tools that support company's moving up along the value chain. We argue here for indirect measures related to business environment, human capital development etc.²⁹

Clusters

There is a wide set of theoretical literature on basics of clusters (Humphrey and Schmitz 2002; Porter 1990, 1998, 2000; Roelandt and Hertog 1999). Clusters could be treated as a national phenomenon or as a regional feature. The size of the country is one important factor that determines the role of cluster. In big countries like UK or Poland, clusters are more regional features. In small countries they could be a national phenomenon. In tiny countries like Estonia, the cluster approach works if the country as a whole is considered to be a part of some larger territorial unit like Scandinavia.

A large number of measures may fall under the heading of cluster policy. Among the various approaches are (Andersson et al. 2004): 1) broker policies aimed at strengthening the framework for dialogue and cooperation by various relevant stakeholders involved in clusters, and not favoring individual players; 2) demand side policies should seek to increase openness to new ideas and innovative solutions; 3) training policies that may be targeted at upgrading skills and competencies which are essential for effective clustering of SMEs; 4) promotion of international linkages that should be designed with a view to enhancing the interplay between foreign and domestic actors; 5) framework policies that should put in place an over-riding playing field marked by effective and consistent rules for inter-actor transactions.

²⁹ On value chains in different industries, see Fujita et al. 1999; Gereffi 1995, 1999; Gereffi et al. 2003.

Cluster policies have likewise become widespread since the early 1990s. The national approaches to cluster policy are very diverse in nature, as the policies are embedded in different business environments, cultural and institutional framework, as well as different governance systems. Some countries have a distinct cluster policy that aims to support national and regional clusters in different ways (Belgium, Denmark, France, Netherlands, Portugal, Luxemburg, UK). A national cluster program has also been launched very recently in Sweden. Other countries have specific regional cluster instruments. In these cases, the promotion of clustering is used as an element of innovation and regional policies (Austria, Finland, Spain, Germany, Italy, Norway). Still other countries (Liechtenstein, Ireland) have neither a national cluster policy nor specific cluster instruments. Roelandt, den Hertog (1999) and Andersson *et al.* (2004) provide an overview of certain kinds of failures and policy responses in general across countries.³⁰

Estonia's economy is too small to create own clusters. At the same time, deep integration with Scandinavian economies brought together also integration into Scandinavian clusters, first of all in electronics industry but to a smaller extent also in garment industry. Developments in these industries are discussed afterwards in the current paper.

Local (regional) level

The traditional location policy addressed three issues: real estate is made available and infrastructure is improved; attraction of external investors is an important issue and facilitation of communication between the business community and public sector is considered valuable for creation of support to policy decisions.

As competition between potential locations became more intense, local actors started to pursue a more ambitious approach, which included at least one of the following elements: 1) the creation of roundtables, partnerships (including public-private partnerships) or alliances for local economic development in order to formulate and implement a strategy to improve the locational advantage or revitalize old locations; 2) the implementation of cluster initiatives; 3) the creation of dedicated local economic development agencies to coordinate and organize local level efforts (OECD 2001; Wallis 1996).

Specific regional policies to encourage investment in particular parts of a country form a major element of the national policy framework in many countries. While MNEs usually long-list countries rather than regions, it is at the sub-national level that MNEs draw up a short list of investment locations for in-depth evaluation and the policies and facilitation of regional agencies often play a critical role in determining who wins a mobile investment project.

A regional cluster policy can be by definition a policy aimed to sustain existing clusters or to support the growth of starting up clusters. The cluster approach should allow the regional

³⁰ There is a long experience of implementing different policy methods in countries. So, for inefficient functioning of markets, policy response has been competition policy and regulatory reform (in many countries). In the case of information failures, policy response has been technology foresight (Netherlands, Sweden), strategic market information and strategic cluster studies (Denmark, Finland, Netherlands). In the case of limited interaction between actors in innovation systems, policy response has been broker and networking agencies and schemes (Denmark, Netherlands), provision of platforms for constructive dialogue (Austria, Denmark, Finland, Germany, Netherlands, Sweden, United Kingdom), facilitation of cooperation in networks (Belgium, Finland, Netherlands, United Kingdom). Institutional mismatches between (public) knowledge infrastructure and market needs has been responded by joint industry-research centers of excellence (Belgium, Denmark, Finland, Netherlands, Spain, Sweden), with facilitation of joint industry-research cooperation (Finland, Spain, Sweden), human capital development (Denmark, Sweden), with technology transfer programs (Spain). Missing demanding customer was substituted by public procurement policy (Austria, Netherlands, Sweden, Denmark). Government failure has been addressed with privatization (most countries), horizontal policy making (Denmark, Finland), public consultancy (Netherlands), reduction of government interference (United Kingdom).

system to move from more traditional policies based on infrastructure building and technological support to a more comprehensive policy trying to improve the environment in which firms and local actors operate. The keyword for such cluster policies is the improvement of regional competitiveness.

The policy also emphasizes the link of firms to the (regional) technological infrastructure of higher education and R&D institutions in which knowledge irrigates the regional economy. The policy in particular tries to bring new technology to regional networks of SMEs. More cooperation may demand attempts to change attitudes in both the technological infrastructure and in firms. Thus, regionally located higher education, research institutions and technology transfer infrastructure should develop their competence and services to be more appropriate for local firms, and SMEs in particular should learn to use R&D when innovating.

Although the approach and phrasing differ, the national policies share a number of key objectives and characteristics. The cluster policy (and to some extent also cluster instruments) deals with broader issues as it is seen as a mean to promote economic development and structural changes, often through enhancing (regional) innovation capacity. The policy often stresses the need to be globally competitive in the “new economy”. The policy is based on improved business cooperation and networking, which may demand the stimulation of social processes (European Union 2005c).

Imbroscio and Williamson (2003) propose local policy responses to globalization. With ownership and control held in a more collective or community-oriented fashion, such enterprises tend to anchor or root investment more securely in communities, providing a counterforce to globalization. Six models are: 1) community-owned corporations (they are similar to traditional corporations save one crucial factor: they are owned primarily by citizens living in or strongly connected to the local community); 2) non-profit corporations (for example, in USA they account for over 6% of economy and over 7% of total employment); 3) municipal enterprise; 4) consumer cooperatives (they are self-help economic structures that provide quality goods and services to their members at a reasonable cost); 5) employee ownership (analysts see worker-owned firms as a means to bring democracy to the workplace or enhance employees' incomes, but these firms also potentially can contribute a great deal to economic stability of communities); 6) community development corporations (those are non-profit organizations dedicated to bringing about the community economic stabilization of a clearly denned geographic area).

In Estonia, regional policy did not play an important role in supporting business activities. Concentration of infrastructure, FDI and domestic investments in capital area created its economic domination. Afterwards increasing rental prices and other production costs started to be the main factor pushing out investments into other regions. University town Tartu in South Estonia played some balancing role in regional scene, but its capacity has been too modest to create any counterweight to Tallinn, the capital city.

Sectors

Industrial policy has a different status among other economic policies depending on how deep are interventionist attitudes of the government. Horizontal industrial policy is targeted at more general conditions of economic environment and could be seen as more emphasized also in the EU. Hierarchical industrial policy has been targeted at particular sectors.³¹ Though

³¹ The special set of problems related to possibility of industrial policy concern economic restructuring in post-socialist countries. The dominating concept in the beginning of reforms was that creation of markets through price liberalization, opening of domestic markets to foreign trade, ownership reform, inflow of FDI, development of financial system, new labor market relations are fundamental and there is no place for industrial policy. One important argument has been that changes were so massive

it has been less used recently, it seems to be become important in the case of delocalization. When sectors enter a decline stage, growth becomes negative for a variety of reasons including international competition (low-cost foreign competition pushing sector into decline). Within a declining industry, the degree of rivalry among established companies usually increases. Depending on the speed of the decline and the height of exit barriers, competitive pressure can become as fierce as in the shakeout stage. That makes companies in the declining sector look for state support.

One reason for orientation to some sectors is related to the reason that for certain reasons the whole sector will be damaged by global foreign shocks. In that case, dealing with sector in crisis is rational. Decline of several manufacturing sectors like clothing, textile, shipbuilding in European countries could be cases to investigate.³²

It is common for investment promotion agencies to specify their priorities in the terms of sectors. By some authors, this leads to misdirection of industrial promotion efforts. The targets of public support should be viewed not as sectors but as activities (Rodrik 2004). This facilitates structuring the support as a corrective to specific market failures instead of generic support for this or that sector. Rather than providing investment incentives for some sector, government programs should subsidize bilingual training, feasibility reports, infrastructure investment, adaptation of foreign technology to local conditions, risk and venture capital.

The role of industrial associations has been important in dealing with sectors' problems.

Electronics

The main impact on manufacturing comes from overall economic policies. Electronics industry has been also influenced by policies in the field of technology, defense, education and trade.

It is a specific industry because it employs a relatively big number of highly educated engineers, medium educated workers and people with basic skills. Another reason is that electronics industry is using relatively few materials, until nowadays not causing remarkable environmental problems and as an innovative industry gives high profits.

The first and most visible policy from promoting electronics and software industries in emerging economies is preparing of engineers and scientists. Educating of engineers in most of the technology areas requires substantial investments from universities and personal efforts from students. The number and quality of engineers are the concern of governments in highly developed and emerging economies. The USA and UK have used simplified visa requirements for programmers, engineers and other highly qualified workers (UNESCO 2005).

Another area of government interference is support for research and development activities. Electronics industry is a knowledge-intensive activity and support to research can create a sustainable competitive advantage. Often the main creation centers of electronics industry are located in nearby universities and public laboratories and government grants help to raise the general scientific and technological knowledge in the area.

Closely related to the government research support is public procurement. Public procurement of military, space and aviation products has fostered technological

and unpredictable that there were no resources to support declining industries with industrial policy tools. Only afterwards the role of institutions and more complex policy measures have been recommended. However, there were also voices arguing for industrial policy approach during the earlier stage of reforms (see, Landesmann and Ábel 1995).

³² See, Aldcroft (1994).

development. In some countries public sector is still the owner or major shareholder in telecommunications. Purchasing of telecommunication goods can therefore be influenced by the public sector.

Last but not least, a major role in public policy is played by standardization. Despite not being directly governmental activity, standards remain an important tool in trade practice. Bigger countries with dominating firms are in favor of common standards and weaker and smaller counterparts try to protect themselves by using different standards. Development of Estonia's electronics industry has not been an exception to these general trends.

After major changes in 1990s, Estonia's electronics industry started to be largely consolidated, heavily export oriented (90-95% of outputs are exported in most of the companies) and based on foreign capital. Empirical evidences (exports-imports, ownership, FDI, value added) show that the Estonian electronics industry is part of the larger Nordic electronics industry cluster. The main branches are the same as those of Finland and Sweden.

As most of Estonia's electronics industry companies are operating in low part of the value chain, this industry is quite sensitive to wage pressures. Delocalization through FDI and subcontracting would move out quite big proportion of production from Estonia. That emphasizes the role of strategy and development of local resources.

The global market of electronics components is a very liberal and competitive one with large production volumes based on economies of scale and high degree of specialization. Competitiveness on those markets needs high level of investments in R&D and equipment. Due to the small size and limited domestic resources, Estonian enterprises are potential developers of niche products. The quality of industries innovation system will be a very critical factor for future development.

Garment Industry

The garment industry was the first branch of the manufacturing industry in Estonia that overcame the structural crisis early in the 1990s. As this is a branch with low capital intensity, the restructuring occurred quite rapidly due to the FDI from Scandinavian countries. The agreements with the European Free Trade Association (EFTA) and the Association Agreement with the EU played also a very positive role. Those agreements abolished customs duties for final products and introduced cumulative application of rules of origin.

In 2000s, the situation changed in terms that companies based continuously on subcontracting who did not manage to introduce own models and trademarks had to meet severe competition from low wage countries. Possible ways of adaptation have been moving out production of low cost models and operation to the CIS and China. The former production companies started to be first of all wholesale and retail sale companies (*Baltika* is an example).

Another way of adaptation has been delocalization of production regionally inside Estonia. Eastern Estonia with lower wage level than the capital area has been one target region. However, it is not clear how long this difference will make competition possible with low wage areas. Probably that is a transition period solution that postpones for a certain period taking of necessary strategic decisions related to location of production units.

The companies have been organized into the Estonian Clothing and Textile Association (ECTA) founded in 1993. The main goal of the ECTA is to promote development of the

clothing and textile industry and represent and protect common interests. The ECTA is a member of the European Clothing and Textile Association (EURATEX).

Information, consultations and some possibilities to have impact on the EU level policy decisions concerning, for example, textile imports from third countries have been the main advantage of being part of international community related to this industry.

Conclusions

It is possible to distinguish between policies that form a general framework for entrepreneurship (a general legislation of business activities, taxes, social security costs and benefits) and policies that are focused to support particular fields or activities (foreign trade policy, innovation policy, active labor market policy, tools to promote investments or FDI in particular field).

We assumed that certain policies are more frequently applied and influential at particular institutional levels. The particular policies at different levels could be supportive to each other or there could be also contradictions and negative side effects of different policies on each other. Innovation activities at regional and national levels support each other. There are several evidences that innovation policy measures and labor policy measures could produce mixed results and not support each other.

The globalization process linking together more and more areas, activities and persons into the process of development, seems to be an important factor in determining trends at the level of the EU and national governments. For our study, the increasing trade, capital mobility and widespread diffusion of technology are the most influential factors of interdependence of countries, which is the basis for economic side of globalization.

The overlapping jurisdiction and regulation issues concern the impact of regulations in the field of social protection and labor market issues on the EU level and division of responsibilities between the EU institutions and national governments. That issue is linked closely to the general choice between more market based or more intervention based policies and determines scale and scope of measures applied at the EU level and their influence through harmonization efforts on national policies. In the context of our study, we can evaluate assumptions and results of different approaches to delocalization process.

The relationship between the MNEs and different level governments is one important issue in internationalization of economic activities. The critical areas where economic interests and public policies meet are the labor market regulations, the FDI related problems, innovation, industrial policy.

Subcontracting, outsourcing, off-shoring and offshore outsourcing, value chain and clusters are the specific concepts that describe different forms in which organizational and technological capacities have been matched together.

Electronics and garment industries are two branches that are both influenced by internationalization of business. Their starting positions for development have been quite different, garment industry having long traditions and in this sense very different from electronics with much shorter history.

At the same time, there are several similarities in current positions of industries. Location in value chain, innovation, role of FDI have determined development of both industries. There is also a very clear and strong competitive pressure from low wage countries that makes adjustment strategies very important in the future.

Integration with respective Scandinavian clusters has been important for both industries. The critical aspects for future development are connected to fate of those clusters and their adjustment strategies. Also position of Estonia's companies in value chain is a very critical factor.

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Spanish industrial employment, vertical specialisation and outsourcing to the EU candidates

M^a Ángeles Cadarso Vecina, Nuria Gómez Sanz, Luis Antonio López Santiago & M^a Ángeles Tobarra Gómez

Facultad de Ciencias Económicas y Empresariales de Albacete,
Universidad de Castilla – La Mancha³³

Abstract

The aim of this paper is to investigate the effect of foreign outsourcing, particularly to new EU members and candidate countries, on the level of employment in Spain. The rising economic integration has increased trade not only in final goods but also the flows of intermediate goods, as a result of the fragmentation of production by multinational firms and/or the search for new and cheaper providers. While some see this phenomenon as a threat to domestic employment, it also represents a chance to reduce costs, increase flexibility and open new markets, all of which can raise sales and employment. We empirically study the impact of this on Spain, a country which joined the EEC in 1986, becoming a low-cost location for many firms. After twenty years of development Spain is now experiencing a strong increase in outsourcing to Central and Eastern European countries.

Using data on trade and input-output tables we describe the evolution of Spanish imports with particular attention to the changes in their sectoral distribution and country of origin. In particular, we present data on vertical specialisation and outsourcing measures for Spain since the middle 1990s. We will follow Hummels et al. (2001) for the calculation of vertical specialisation measures but we will distinguish by country of imports.

Following recent literature on the topic, such as Feenstra & Hanson (1999), Strauss-Kahn (2004) and Hijzen et al. (2005), outsourcing is measured by intra-industrial imports of inputs, using domestic and import –use matrices of input-output tables for 92 Spanish manufacturing industries for the period 1993 to 2003. We are interested in outsourcing to particular countries and groups of countries. We use a similar methodology to Egger & Egger (2003, 2005), Falk & Wolfmayr (2005) and Geishecker (2005), and calculate outsourcing to those countries using our measure of outsourcing and data on imports from the National Customs Agency.

These outsourcing measures are included in a labour demand function estimated using annual data from the *Industrial Survey* (Spanish Statistics Institute) on hours worked, added value (net sales minus intermediate purchases) and labour cost. The most appropriate method of estimation for this panel data, with a lagged dependent variable and endogenous and predetermined variables among the regressors, appears to be the GMM system technique (SYS-GMM).

We find that the effect of outsourcing differs with industry characteristics, being negative and significant for medium and high-tech industries and not significant for low-tech sectors. Comparing the effect for new EU members and candidates our results show a greater negative impact from outsourcing to EU candidates, especially Turkey, on Spanish industrial employment.

³³ Plaza de la Universidad nº 1, 02071, Albacete (Spain). MariaAngeles.Tobarra@uclm.es.

Introduction

In the context of growing international trade, the forthcoming EU enlargement as well as that of 2004 have provoked intense commercial relationships between Central and Eastern European countries and the EU-15. As a consequence, the productive structure of the involved countries is changing with effects on production and employment for all sectors, within a general tendency to sectoral specialisation. This process mirrors that of Spain back in 1986, when its entry into the EEC (European Economic Community) greatly contributed to growth and structural change in the country due to intense trade, multinational enterprises' activity and increasing specialisation in some types of manufacturing, particularly the production of motor vehicles. It also implied changes in the rest of the EEC as relocation of some activities and trade diversion took place, allowing cost reductions in European firms and the re-structuring of some activities, particularly labour-intensive ones.

The increase in the exchange of intermediate inputs is one of the effects of this greater international integration, involving a substitution between domestic and foreign purchases. In a previous paper (Cadarsó et al. 2006) we found that for the Spanish economy: a) inter-industry domestic input purchases over production have decreased by 24% over the period 1995-2000, while their foreign counterpart increased by 32%; b) intra-industrial domestic input purchases increased by 10% between 1995 and 2000, while intra-industrial imports grew by 41%; and c) another striking aspect of "new trade" is reflected in the important growth of the requirements of total inputs bought from other countries for Spanish production and export or Spanish vertical specialisation (which has increased from 0.298 to 0.348 between 1995 and 2000). In this paper we will focus on the importance of these phenomena (outsourcing and vertical specialisation) on the Spanish economy, with special attention to the role of Central and Eastern European (CEE) countries and Turkey on this process.

We can be more specific and point out that there is a substitution not only between domestic and foreign purchases but also in terms of countries of origin for those imports. Although more than half of all Spanish imports are still bought from EU-15 countries, there is now an increasing role for new members and candidates in this trade. While their weight in total Spanish imports is still low, imports from CEE countries rose by 82% between 1999 and 2003. Among these countries the evolution of imports from Turkey is remarkable. Although from a very low starting point, Spanish imports from Turkey have grown during the 1995-2003 period at an annual rate above 49%, well over the total of Spanish imports, which only grew at an annual rate of 11.6%.

The sectoral distribution of outsourcing is key to understanding this process. As explained by Feenstra and Hanson (1996), outsourcing requires two conditions to occur. Firstly, the production process can be separated into self-contained stages. Secondly, production stages vary considerably in the relative intensity with which they use labour of different skill types. These conditions are especially easy to meet in industrial production, where outsourcing is a natural development of subcontracting, since production stages are firstly fragmented and, when possible, moved abroad. Differences in wage levels have been recognised as the main reason behind outsourcing in most of the literature, but some other factors can also be at work (e.g. different types of skilled labour, economies of scale of specialised providers, uncertainty in some product characteristics, etc.), reinforcing the importance of different origins for inputs.

We will distinguish two groups of sectors out of 92 manufacturing branches: low-tech and medium and high technology sectors (see appendix I for a complete list). The first type includes *Food related sectors, Textiles and related industries, Wood products, Paper, Publishing, Furniture* and various other industries (from 151 to 223 and 361 to 233 NACE) while medium and high technology sectors include *Chemicals, Materials, Metallic products, Electrical and electronic products, Vehicles and related products* and so on (from 241 to 355

NACE). The rise in outsourcing (defined as imported intermediate purchases from the same sector) has been especially pronounced for the second group: 52% compared to 19% for low-tech. This is the result of the Spanish productive structure, which shows a specialisation in traditional (low-tech) industries and a lack of competitiveness in high-tech³⁴. The Spanish economy therefore needs to import high-tech inputs while low-tech sectors can use domestically produced inputs to a greater extent.

Firms outsource part of their production as a tool to compete in an increasingly globalised world. In this fashion sometimes they locate part of their production in countries where they find advantages. Sometimes they simply import from external providers located in these countries. This fragmentation of production makes those firms more competitive, particularly in terms of prices, allowing them to increase their share in foreign markets by means of exports. The term “vertical specialisation”, proposed by Hummels et al. (2001), simultaneously relates the fragmentation of production and exports by sector of activity, as it calculates the direct and indirect imported inputs that are included in a country’s exports. Using this measure we account for the fact that in the making of a product there are at least two countries interacting sequentially and that the final destination of that product is a country other than the one where the last production stage takes place. This is why we have also calculated the vertical specialisation by country, so we can not only see the sectors, but also the countries that are part of the production chain together with Spain.

Besides describing the evolution of Spanish imports, vertical specialisation and outsourcing to EU candidates, this paper also investigates the effect of this outsourcing on the level of employment. Our empirical analysis is therefore characterised by: 1) using data from the import-use matrices of input-output tables, rather than it being indirectly estimated through weighting trade data; 2) estimating a labour demand function, at sector level, studying the effects of employment instead of focusing on skills or wages like most of the literature³⁵; 3) using dynamic panel data techniques (GMM); 4) differentiating the effect of outsourcing depending on sectoral characteristics (low-tech vs. medium and high-tech); 5) distinguishing between different geographical locations, and focusing on new members and candidates.

Our empirical results point in the direction of a negative impact from outsourcing on domestic employment, but only for medium and high-tech sectors. This negative effect is significant for CEE countries while it is not significant for total imported inputs. Comparing the effect for new EU members and candidates our results show a greater negative impact from outsourcing to EU candidates, especially Turkey, on Spanish industrial employment.

Our paper is structured as follows. In section 2 we review the relevant literature on labour markets and outsourcing. In section 3 we outline the basic model used and the calculation of outsourcing and vertical specialisation measures. Section 4 comments on the data and the evolution of those measures. Section 5 contains the main empirical results for the relationship between outsourcing to different countries and employment in Spain and comments on a number of important econometric issues. Section 6 concludes.

Outsourcing and employment in recent literature

Changes in industrial organisation and technology have been considered by previous literature as the main forces behind changes in labour demand. New production methods

³⁴ This conclusion can be illustrated by looking at facts such as the trade balance (with a much bigger deficit for medium-high-tech sectors), location advantages reflected in the comparatively bigger inward FDI in low-tech sectors (and lower disinvestment between 1993-01, as commented by Myro & Fernández-Otheo, 2004) and increasingly important Spanish MNEs from these sectors.

³⁵ We are only aware of one study by Görg and Hanley (2005) that looks at the effect of outsourcing on employment at firm-level and uses surveys rather than input-output data.

involve the division of production in different stages that are taken to different geographical locations with important effects on employment. A number of papers have analysed this topic in the last decade following the original Feenstra & Hanson (1996) paper. Feenstra & Hanson's novel idea, its developments by other authors and associated empirical applications are reviewed in this section.

Feenstra & Hanson (1996) used the non-production share of workers' share of the industry wage bill as a proxy for the relative demand for skilled labour in an industry. This measure is introduced in a labour cost equation (see Berman et al. 1994) that includes other control variables. They conclude that outsourcing is associated with an increase in relative demand for skilled labour in the US labour market, especially when outsourcing comes from low-wage countries.

This framework was extended in Feenstra & Hanson (1999) as they included, together with the measures of trade, variables to reflect technical change as these are the main forces affecting relative demand for skilled labour. More relevant to our study they further elaborate the definition and measure of outsourcing, identifying three types: narrow, difference and broad. Narrow outsourcing is restricted to imported inputs from the same sector, while difference outsourcing describes intermediate goods imported from sectors other than the one considered (broad outsourcing defines the sum of the other two types).

Empirical applications following Feenstra & Hanson work for European data moved to the estimation of labour demand functions as an alternative to labour cost functions to adjust to the specificities of the European labour market, where labour differences are less important. We comment on some European studies such as Hijzen et al. (2005), Strauss-Kahn (2004) and Görg & Hanley (2005).

Hijzen et al. (2005) empirically investigates the link between international outsourcing and the skill structure of labour demand in the UK by estimating a system of four variable factor demand functions. The relative demand function is augmented by an inter-industrial outsourcing measure, calculated using import-use matrices of input-output tables for manufacturing industries and shows that international outsourcing has had a strong negative effect on the demand for unskilled labour.

A similar result is found in Strauss-Kahn (2004) for 50 French industries, showing that specialisation has contributed appreciably to a decline in the within-industry share of unskilled workers, although "globalisation" is not the only element affecting labour - as skilled-biased technological progress seems more important than outsourcing in explaining the reduction in unskilled labour demand.

Finally, Görg & Hanley (2005) analyse the effect of outsourcing on total labour at the level of the individual plant. They estimate dynamic labour demand for the Irish electronic sector and find that, in the short-term, there are significant reductions in plant-level labour demand explained by international outsourcing. However, the effect of outsourcing depends on the kind of imported intermediate goods, since there appears to be stronger negative effects from outsourcing of materials than from outsourcing services.

In general, empirical applications following Feenstra & Hanson's work and, in most cases, have found a positive effect of outsourcing on skilled labour, pointing to firms contracting out production phases that are low-skilled labour intensive. For labour demand level Görg & Hanley found that outsourcing had a negative effect on employment.

The enlargements in the EU and increasing international openness by some countries have attracted interest to the topic of outsourcing to particular countries or regions affecting

domestic labour differently. Egger & Egger (2003, 2005), Geishecker (2005) and Falk & Wolfmayr (2005) are examples of a very recent and not yet quite developed literature.

Egger & Egger started this type of analysis, focusing on outsourcing from Austria to Central and Eastern European (CEE) countries. Egger & Egger (2003) conclude that 25% of the increase in relative demand for high-skilled labour in Austria was generated by this outsourcing. While Egger & Egger (2005) confirm this effect, even after including a spillover measure together with the outsourcing variable. They conclude that this impact will be even more intense as future enlargements include more Eastern economies and they increase their trade links with EU countries. Also, for Austria and Germany, a later paper by Geishecker (2005) found a link between outsourcing to CEE countries and the decrease in relative demand for low-skilled (manual) workers.

Falk & Wolfmayr (2005), a study with a broader scope, considers information for manufacturing industries in seven EU countries for the period 1995-2000. Their results are consistent with the previous papers as they find a negative impact on the level of employment, particularly for low-skilled sectors, from outsourcing to imports from low-wage countries (CEE, NICs and other East Asian countries).

Although the analysis of CEE countries' trade with other European countries has received attention from economists in recent years, to the best of our knowledge, there are no studies analysing the importance of outsourcing to Turkey for either labour or productivity in the outsourcing country.

Finally, Hummels et al. (2001) develops the concept of vertical specialisation, as mentioned above. This term refers to the direct and indirect (total) imports of inputs required to produce the goods that are exported by a country. These authors conclude that this specialisation deepened for 10 OECD countries between 1970 and 1990. Minondo & Rubert (2002) show that, between 1970 and 1994, the Spanish economy reached similar values to the vertical specialisation of medium-sized OECD countries. This concept includes that of broad outsourcing (and extends it) as it considers not only direct, but also indirect inputs.

Our study will combine elements from all of these papers. We will use the definitions of outsourcing from Feenstra & Hanson, although our measures will be constructed slightly differently. We will follow Görg & Hanley in estimating a dynamic relationship, rather than a static equation, as in most of the literature. We will focus on the effect of outsourcing on the level of employment as in Görg & Hanley and Falk & Wolfmayr, and not on relative skill demand. We will distinguish outsourcing from different countries / groups of countries, as in Egger & Egger, Geishecker, and Falk & Wolfmayr; and we will also describe the evolution of vertical specialisation, as in Hummels et al., but with disaggregated figures according to the source country.

Labour demand equations and calculation of outsourcing and vertical specialisation measures

In contrast to most of the literature reviewed in section 2, we will focus on the impact of outsourcing on employment, rather than wages or relative skill-labour demand, at sector level. In order to do this, our empirical study estimates a dynamic labour demand function derived from a CES production function (wherein we include a measure of outsourcing).

Starting from the CES production function and following the usual procedure of first-order conditions we can obtain the labour demand function augmented with outsourcing and fitted to panel data:

$$n_{it} = \alpha_0 y_{it} + \alpha_1 w_{it} + \alpha_2 outsourcing_{it} + (\varepsilon_i + u_{it}) \quad (1)$$

where $i = 1, \dots, N$ sectors and $t = 1, \dots, T$ years, n is employment, y is output, w is (real) labour cost (all in logarithms), ε are sector-specific (time-invariant) effects and u is the usual error term.

Equation (1) can be understood as a static or long-term equilibrium relationship but it does not take into account possible dynamic or short-term effects. Therefore, we will estimate the following dynamic specification:

$$n_{it} = \alpha_0 n_{it-1} + \alpha_1 y_{it} + \alpha_2 w_{it} + \alpha_3 outsourcing_{it} + (\varepsilon_i + u_{it}) \quad (2)$$

It is possible to find the value of the long-term coefficient for all the variables in expression (2) from the short-term estimated coefficients. Equation (2) must be regarded as a first approach to the dynamic structure of the link between these variables. Additional regressions were performed, including further lags of these variables, to check the adequacy of the specification.

With respect to the variable outsourcing included in the regressions, it is calculated from data in the use matrices of the Spanish input-output tables (commodity by sector). These matrices show the input structure for the different sectors (including secondary production) in columns, as they decompose output value into intermediate consumption and remuneration to primary inputs. Rows in the use matrix distribute production between intermediate demand and final demand³⁶.

Employing use matrices rather than symmetrical matrices gives us a time span with six use tables (1995-2000)³⁷ for one symmetrical table in the period of study (1993-2003). It is fundamental to include the change in the coefficients for both domestic and imported inputs, as outsourcing in the Spanish economy is a rapidly increasing phenomenon. Spanish use matrices distinguish between domestic and imported inputs, allowing us to directly measure international outsourcing as in Hijzen et al. (2005). This is an advantage compared to other international data, such as those used by Feenstra and Hanson (1996, 1999), Egger and Egger (2003, 2005) and Strauss-Kahn (2004) which need to combine input-output tables and trade data to create a proxy for imported inputs by sector.

Of the different measures of outsourcing considered in the literature, we will focus on narrow outsourcing (outsourcing from now onwards) i.e. intra-industrial imported inputs. We will calculate both total (all countries) outsourcing and outsourcing by country of origin for Spanish manufacturing industries. Our outsourcing measure is obtained by dividing imported inputs purchased from the same type of commodity by effective production³⁸:

$$narrow \text{ outsourcing}_{it} = m_{iit} = \left(\frac{Imported \ Inputs_{ijt}^{World}}{Production_{jt}} \right), \forall i = j \quad (3)$$

We can calculate this measure according to the country (or group of countries) of origin of the inputs; for example, Turkey's narrow outsourcing measure is obtained thus:

³⁶ The main difference with respect to the inter-industry symmetrical (commodity by commodity) matrix is that the latter includes inter-sectoral flows (both in columns and in rows) in terms of "pure industries" or "commodities". In this fashion, secondary production for each sector is relocated to its corresponding "pure industry". Nevertheless, 90% of total production is main production.

³⁷ It is possible to observe a very important change in the coefficients from 1995 to 2000. This is why, to fill the gaps, we estimate the data for 1993 and 1994 by extrapolating the growth rates from 1995-1998 and, for 2001 and 2002, we apply the growth rates from 1998-2000.

³⁸ We divide by effective production, as in Egger & Egger (2003) and Strauss-Kahn (2003), while Hijzen et al. (2004) divide by added value, Görg & Hanley divide by total wages, and Feenstra & Hanson (1996) divide by total non-energy purchases.

$$Turkey \text{ narrow outsourcing}_{jt} = \left(\frac{Imported \ Inputs_{ijt}^{World}}{Production_{jt}} \right) \cdot \left(\frac{Total \ Imports_{it}^{Turkey}}{Total \ Imports_{it}^{World}} \right), \forall i = j \quad (4)$$

To calculate this measure we weight our previous narrow outsourcing measure by a new term. This term is the ratio of imports from Turkey of commodity i relative to total imports of commodity i ³⁹. An equivalent measure has been calculated for the group of CEE countries (new EU members and candidates).

The calculation of outsourcing allows us to take into account the content of imports for any domestic product, or equivalently, the foreign added value included in domestic production. The term vertical specialisation simultaneously relates to the fragmentation of production and exports by sector, as it calculates the total (direct and indirect) imported inputs included in exports. In this way we can describe how countries are increasingly involved in production in a sequential fashion⁴⁰.

The calculation of vertical specialisation that we use in this paper is slightly different from Hummels et al. (2001). We use the following formula:

$$EV = M(I - D)^{-1} < X > \quad (5)$$

Where M is the matrix of imports coefficients, D is the matrix of domestic coefficients, and X is the diagonalised vector of exports. This diagonalisation in the last term is the main difference between our calculation and that of Hummels et al. The advantage of this formulation is that we can then obtain two types of information:

- On the one hand the sum of the elements contained in the columns of the resulting matrix tells us the intermediate imports of all products that are directly (or indirectly) required to obtain the exports of a sector;
- On the other hand the sum of the elements contained in the rows allows us to calculate the total content of intermediate imports of a particular input for all of the exports of a country. This is the information used in Hummels et al. and Minondo & Rubert (2002) for the Spanish economy until 1995 and it results from the expression above without diagonalising the vector of exports.

It is important to note that vertical specialisation represents the content of total (direct and indirect) intermediate imports included in Spanish exports, while the outsourcing measures only consider direct inputs.

Finally, we propose a new concept: vertical specialisation by country of origin. By combining input-output tables and foreign country trade data it is possible to find the countries that conform to the Spanish production chain. The formula used is:

$$VS = P'M(I - D)^{-1} < X > \quad (6)$$

Where: P is an $m \times n$ matrix that shows the imports percentage participation per country for each type of goods, m being the countries (see table) and n the goods; M is an $n \times n$ imports coefficient matrix; D is an $n \times n$ matrix of domestic coefficients and X is the diagonalised $n \times n$ vector of exports. Results for 10 groups of countries are shown in the next section.

³⁹ This implies that we suppose the same distribution of intermediate inputs by country as total imports (intermediates plus final). Ideally we should only include intermediate inputs.

⁴⁰ The vertical specialization shows, up to a point, the lack in the production of different intermediate goods as it describes the inputs that our country needs to import, in order to produce and export. However, once the goods are exported, the available data cannot tell whether the production of these goods has been completed as it does not distinguish between exports of final and intermediate goods.

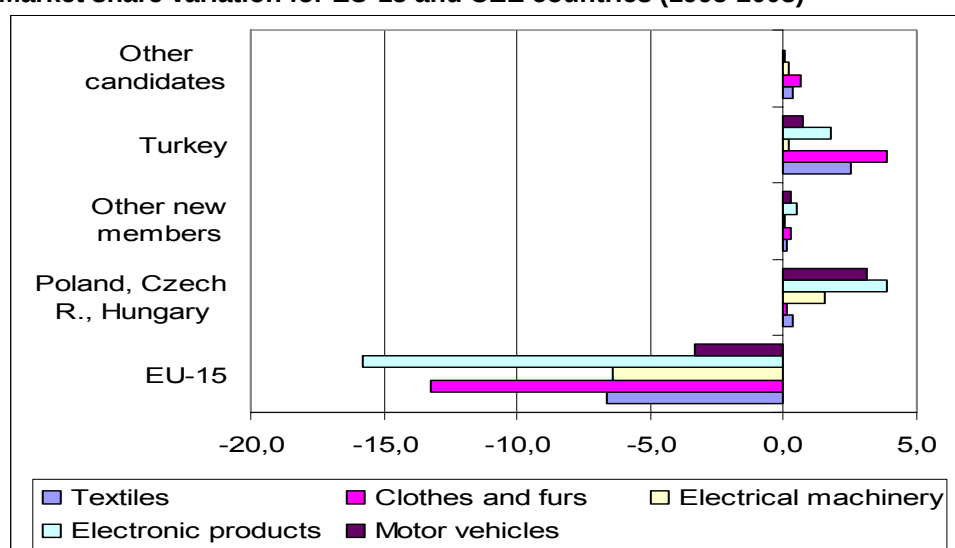
Outsourcing, vertical specialisation and trade patterns in Spanish manufacturing: countries and sectors

Spanish imports and their distribution by type of product and origin

Spanish foreign trade increased during the period under analysis. The rate of openness was 28% at the beginning of the nineties and 43% in 2003. This growth is shared by exports and imports and both have shown higher nominal growth rates than GDP. Nevertheless, Spanish imports have grown over and above exports and the propensity to import has risen by nearly 50% over the last ten years. A wide range of countries provide Spain with commodities but, as expected, the European Union (EU-15) is our primary supplier with more than 60% of Spanish imports.

Spanish imports are increasingly originated in the European and Asian (India, Thailand, China and South Korea) regions, with imports from other areas (such as Other Asian countries, Africa, Oceania and America) decreasing in relative terms. The fast evolution of these Asian and some of the new EU members and candidates is particularly remarkable for specific products, to some degree replacing the EU-15 countries as Spanish providers. Figure 1 shows a large increase for Poland, Czech R. and Hungary among the new members and Turkey among the candidates. Turkey is the European country with the fastest growth in some of these commodities, which justifies a detailed study.

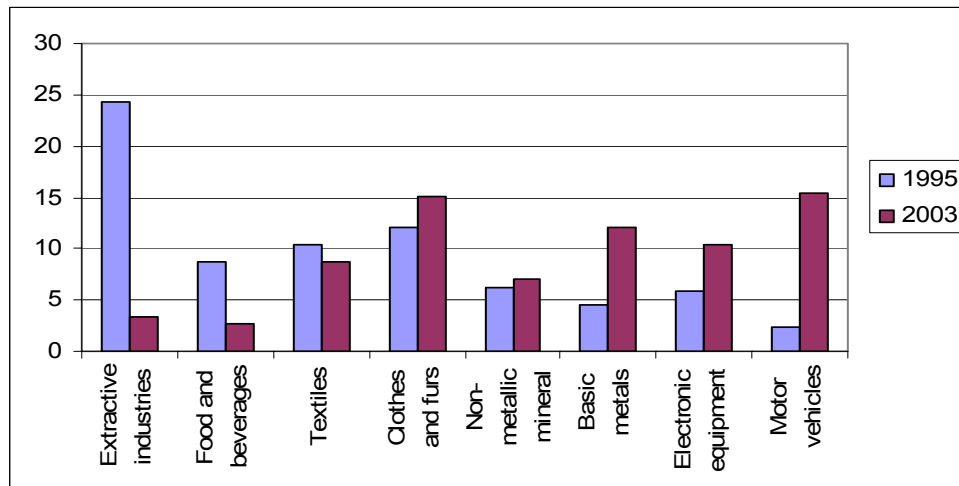
Figure 1 Market share variation for EU-15 and CEE countries (1995-2003)⁴¹



The case for Turkey is consistent with that of all of the CEE countries. Turkish imports have increased by 155% during the period 1995-2003, continuing a general pattern that started during the 80s. Among the reasons which explain the strengthening of Spanish-Turkish trade are: the Turkish foreign trade regime reform that took place during the 1980s, the Spanish entrance into the EU, Turkish Customs Union which was agreed with the European Union in 1996 and its subsequent negotiations as a candidate, and more generally, the actual tendency to increase global trade due to international integration. Within this framework Spanish-Turkish trade is moving towards the modern trend of growing intra-industrial-trade, which has increased from 16.8% of total trade in 1989 to 37.6% in 2002 (see Narin 2005). Since, according to Narin, vertical outsourcing (intra-industrial trade of different qualities of product) accounts for about 82.3% of outsourcing, cost differences are the main argument for Spanish-Turkish intra-industrial trade.

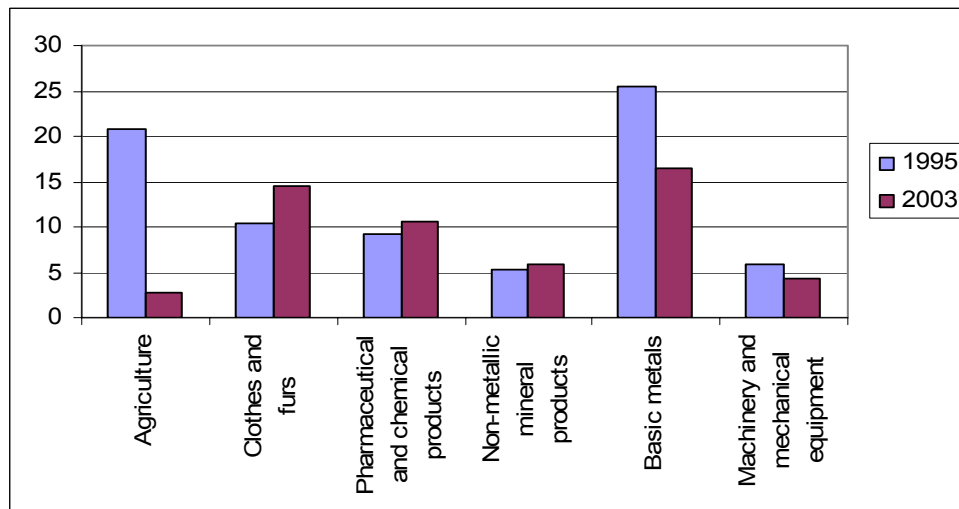
⁴¹ Source: Own elaboration. Data from the *Cámara de Comercio* and *INE* databases.

Figure 2 Spanish imports from Turkey (Percentage distribution)⁴²



Spanish-Turkish exchange is still very low, covering only 1% of Spanish imports. Even though the total weight of imports from Turkey is low for the whole economy, it is nevertheless an important supplier of specific goods due to Turkey's productive specialisation. In 2003 Turkish products represented 5.6% and 3.9% of Spanish imports of *Clothes* and *Textiles* respectively, 5.4% of *Non-metallic mineral products* and 2.3% of *Electronic materials* (see Figure 2). The market share and evolution of Other candidates is far below that of Turkey.

Figure 3 Spanish imports from Other candidates (%)



Outsourcing measures for Spanish manufacturing industries

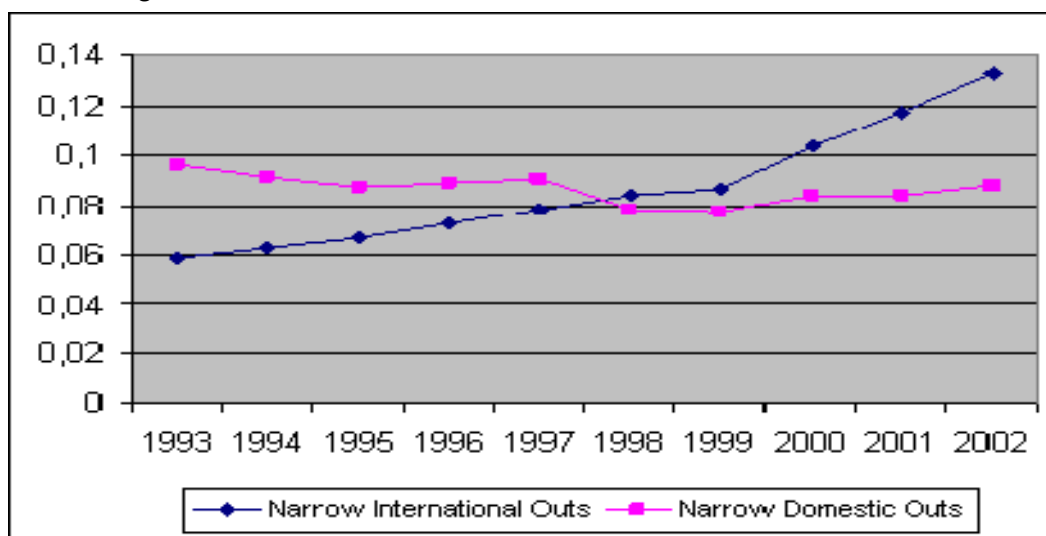
Evolution of the domestic and foreign outsourcing measures

The difference between imports and outsourcing measures is remarkable. While the import data shown above includes final and intermediate goods, outsourcing measures only consider intermediate goods. These are inputs that are part of the production process in the industry that imports them and, therefore, they should be considered when studying delocalisation and vertical integration processes.

⁴² Source: Own elaboration. Data from the *Cámara de Comercio* and *INE* databases.

From our constructed measures of outsourcing, shown in Figure 4, we observe that foreign outsourcing has greatly increased in the period under consideration (imports of manufactured intra-industrial inputs have escalated from 6% to around 14% of total production). Nevertheless, the Spanish manufacturing industry was simultaneously generating employment in this period, and therefore we can regard outsourcing as an additional factor in competitiveness because it allows firms to reduce costs and increase flexibility so that they maintain, and even increase, their production and employment figures. As opposed to this, domestic outsourcing has been fairly stable.

Figure 4 Outsourcing measures⁴³

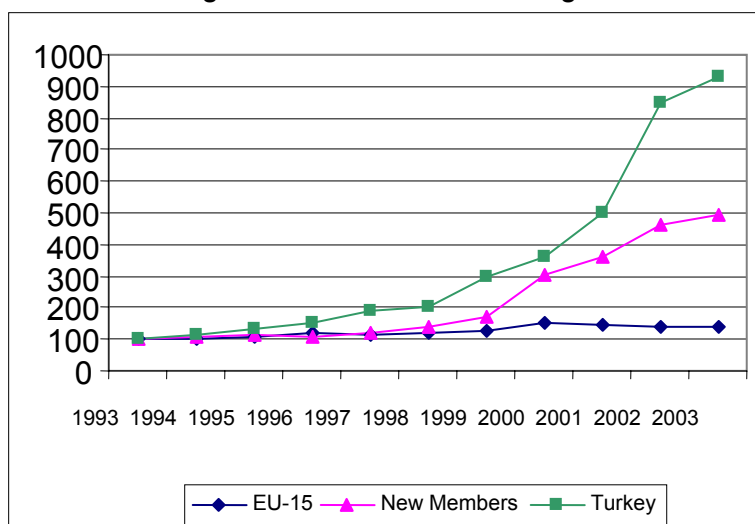


Evolution of the outsourcing measure by country

We calculate different narrow outsourcing measures by country. Our data show that high-wage countries in the EU-15 account for most of the outsourcing: almost 70% of intra-industrial imports. However, recent evolution of these imports is far more favourable to low-wage countries, similar to the results obtained by Falk & Wolfmayr (2005) for EU-7 countries. While Spanish trade with the EU-15 increases by 6.5%, trade with new members rises by 26.85%, and 17.8% with new candidates (in fact, it only increases for Turkey). Most of the substitution is then between domestic and imported inputs from CEE countries, so that the impact on domestic labour demand is expected to be stronger for imports from CEE countries than for inputs imported from other countries.

⁴³ Source: Data from the *Use matrices in the Input–Output Tables* (INE), calculated as explained above.

Figure 5 Medium and high-tech Sectors' Outsourcing to CEE and EU-15⁴⁴



Outsourcing to new EU members and candidates has not been equally distributed among sectors, being of greater significance for medium and high-tech sectors, as shown in Figure 5. While EU-15 outsourcing hardly grew between 1993 and 2003 in these sectors, outsourcing to new members and candidates grew by more than 360%. The pattern is the same for outsourcing in low-tech sectors, 209% to new members and candidates, compared to 28% for the EU-15. As far as the different rates of growth are concerned, impact on labour demand is expected to be greater for medium and high-tech sectors and for CEE countries.

Figure 5 also shows that outsourcing intensifies acutely from 1997-1998, when accession negotiations with Cyprus, Hungary, Poland, Estonia, the Czech Republic and Slovenia (the so-called "Luxembourg Group") started. A new impulse in the outsourcing to new EU members and candidates took place in 1999, when the decision to open negotiations with Romania, Slovakia, Latvia, Lithuania, Bulgaria and Malta (the "Helsinki Group") was taken. The prospect of an open market reduced uncertainty for investors and stimulated FDI, thereby increasing outsourcing.

Vertical specialisation in Spanish manufacturing industries

Evolution of vertical specialisation

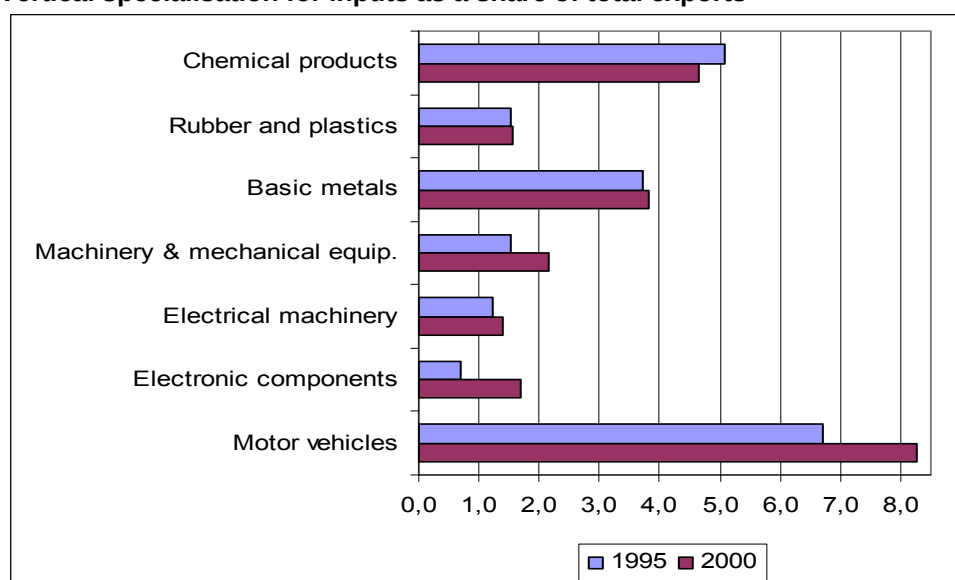
Our results show that vertical specialisation, as a share of total exports for the Spanish economy, has changed between 1995 and 2000 from 0.298 to 0.348, which represents an increase of 17% (see Table 1). This implies that, in 2000, Spanish exports included almost 35% of imported goods either directly or indirectly used in their production. This level and evolution of vertical specialisation is in the same range of results for other EU countries of a similar size (e.g. Germany, France or the UK) from 1979-1990, as in Hummels et al. (2001), and for Spain in 1970-1994 as reported by Minondo & Rubert (2002). This is shown in the following table. Minondo & Rubert also show that in recent years there has been an acceleration of the process of vertical specialisation in Spain. In 1995-2000 its rate of annual change was 1.6 times greater than in 1970-1994.

⁴⁴ Source: Data from the *Use matrices in the Input-Output Tables* (INE) and *Bilateral Trade Database* (OECD), calculated as explained above. Base year 1993=100.

Table 1 Vertical specialization of several countries⁴⁵

	1970	1990	1995	2000
Germany	0.18	0.20	--	--
Australia	0.09	0.11	--	--
Canada	0.20	0.27	--	--
Denmark	0.29	0.29	--	--
USA	0.06	0.11	--	--
France	0.18	0.24	--	--
Ireland	0.35	0.28	--	--
Japan	0.13	0.11	--	--
Netherlands	0.34	0.37	--	--
UK	0.20	0.26	--	--
Spain	0.20	0.26	0.298	0.348

Analysing our results by row, we find the most important imports for Spanish exports (in other words, the vertical specialisation by inputs (Figure 6)). Most of them are medium and high-tech products, with *Motor vehicles* being the most important. This is the input with the highest contribution to Spanish vertical specialisation in the period. 8.3% of Spanish exports in 2000 were produced using imports from the *Motor vehicles* sector. These figures are explained by the characteristics of this sector. It is a sector with high economies of scale, controlled by a reduced number of firms, where fragmentation is relatively easy and it has a very important role in our economy. Nevertheless, the inputs growing fastest are high-tech manufactures and, in particular, *Electronic components* and *Office machinery*⁴⁶. These imports of ICT hardware can be partly accounted for by this industry showing economies of scale and high entry costs. Its production is therefore highly concentrated in some firms and countries (Pilat & Lee, 2001). The Spanish economy has not been able to grow competitive firms in ICT as it requires a large volume of these inputs to have become indispensable inputs in a world where flexibility and adjustment speed are fundamental.

Figure 6 Vertical specialisation for inputs as a share of total exports⁴⁷

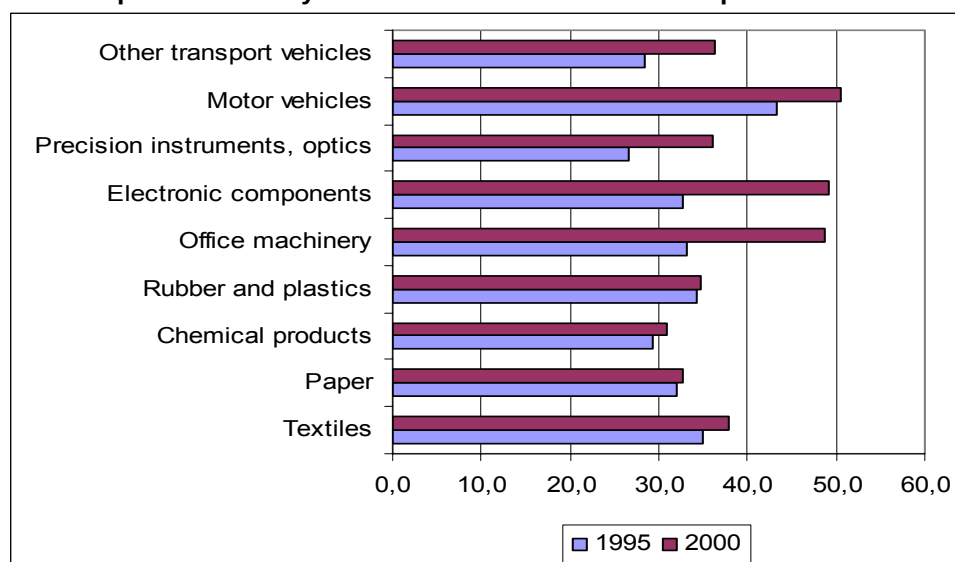
⁴⁵ Source: Minondo y Rubert (2002) for data of Spain 1970 y 1990, own elaboration for Spain 1995 y 2000 and Hummels *et al.* (2001) for the rest of countries in the table.

⁴⁶ There are also high rates of growth in low-tech manufactures, such as *Tobacco* and *Furniture*, but their weight in Spanish exports is still very low.

⁴⁷ Source: Own elaboration using data from input-output tables (INE).

Dividing the figures of vertical specialisation in columns by each sector's exports we calculate a measure of intermediate imports of all products that are required to obtain the exports of a sector. In this fashion we can compare each sector's vertical specialisation and that of the economy as a whole: vertical specialisation for the Spanish economy in 2000 was 0.348, while it varies from 0.114 for the *Extractive* industries to 0.506 for *Motor vehicles*. Sectors with vertical specialization above the average are shown in Figure 7.

Figure 7 Vertical specialization by sector as a share of sector's exports



There is not a clear relationship between the level of vertical specialisation and technology for each sector. Nevertheless, sectors with high growth rate of vertical specialisation in 1995-2000 are those of high technology: *Electronic components*, *Office machinery* and *Precision instruments, optics*.

Vertical specialisation by country

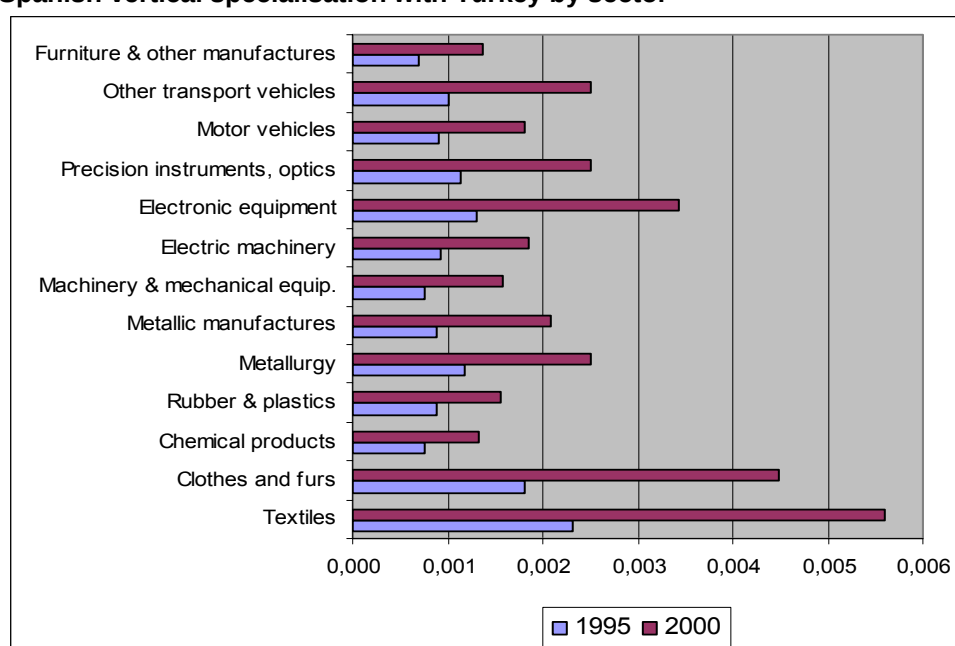
The remarkable increase in Spanish vertical specialisation that took place between 1995 and 2000 is associated with changes in the imports' country of origin. Table 2 shows that Spanish production fragmentation takes place mainly within the EU-15, since over 70% of total import requirements per production and export unit come from this group. However, this trend is growing positively but is still below the mean for All countries, reducing its percentage participation.

Table 2 Vertical specialisation by country

	1995	2000	Variation rate	% participation difference
EU – 15	0.2158	0.2470	14.46	-1.60
Poland, Czech R., Hungary	0.0022	0.0039	78.47	0.38
Other new members⁴⁸	0.0009	0.0015	77.62	0.15
Turkey	0.0009	0.0018	105.32	0.22
Other candidates	0.0011	0.0009	-21.08	-0.12
Other European countries	0.0145	0.0171	18.00	0.04
America	0.0227	0.0218	-4.18	-1.38
India, Thailand, China, South Korea	0.0068	0.0130	90.05	1.43
Other Asian countries	0.0172	0.0218	27.00	0.49
Africa and Oceania	0.0155	0.0195	25.84	0.39
Total	0.2975	0.3482	17.05	0.00

Spanish vertical specialisation with Turkey has grown at an impressive rate during the period and it is expected to keep to this trend in the future, supported by EU-Turkey integration negotiations. Moreover, this growth affects all Spanish sectors as it is shown in Figure 8⁴⁹.

Figure 8 Spanish vertical specialisation with Turkey by sector



Behind Turkey there are other countries (India, Thailand, China, South Korea, Poland, Czech R., Hungary and other new members) where the vertical specialisation rate with Spain is growing remarkably.

Data show the departure of trade with Other candidates (and in a lower proportion, America) with negative variations from both groups. Trade relationships with these two groups have been negatively influenced by the integration of new members into the EU.

Spanish vertical specialisation changes for different groups of countries, and also within each group, changes with sectors. Trade with Turkey and also India, China, Thailand, South Korea and the remaining Asian countries, shows a dual character. On the one hand it is important

⁴⁸ Cyprus, Slovenia, Slovakia, Malta, Estonia, Lithuania and Latvia.

⁴⁹ This Figure only includes the sectors with greater vertical specialization with Turkey as an example.

for low-tech sectors: *Textiles, Clothes, Furs and shoes* (shoes for all groups but Turkey) and on the other hand, is also important for medium and high-tech sectors: *Electronic components, Precision instruments, Motor vehicles* (mainly for Turkey and the remaining Asian countries) and *Office Machinery* (for the whole of Asia).

Outsourcing and employment: empirical analysis

In this section we analyse differences in outsourcing effects depending on sectoral characteristics of the receiving sector and the origin of outsourcing. We focus on the differences between outsourcing from Turkey, from CEE countries and a global outsourcing measure. We also discuss the consistency of our results. Employment is measured by thousands of yearly hours worked per sector. Production is added value (net sales minus buying of intermediate goods) in thousands of €. Labour cost is measured by labour related expenditure per hour worked in €. These data are provided by the Encuesta Industrial (INE) and are deflated for each sector by its industrial price index. As mentioned above, the use input – output tables allow us to include information on how much of the inputs required by one sector are either originated domestically or are imported from the rest of the world. As the calculated measure for outsourcing is directly obtained for 26 manufacturing sectors from the input – output tables, we multiply that figure for different groups of sectors by an estimation of intermediate inputs for our 92 sectors, obtained from data from the Encuesta Industrial and percentages on imported over total inputs from the use matrix. Data for imported commodities for each country have been obtained from the Cámara de Comercio and INE databases. All variables are deflated at base year 2000.

We will use these data to estimate equation (2), above, which includes employment (our dependent variable) lagged one period as a right-hand-side variable. This can seriously bias the coefficients from an OLS regression and suggest the use of different panel data techniques. GMM estimations and particularly the difference GMM (DIF-GMM) technique of Arellano & Bond (1991) is the estimation of choice, given that our equation combines predetermined variables (like labour cost) with endogenous variables (e.g. output) as regressors. The DIF-GMM is an instrumental variable method that involves estimating the equation at hand in differences, rather than in levels, but including lagged values of the regressors as instruments.

As sectoral data implies panels that are rather short and most of the variables included present strong autocorrelation, the instruments in the DIF-GMM might not be enough to get unbiased estimates. Therefore a more elaborate technique, the system GMM (SYS-GMM) technique is in order (see Blundell & Bond, 1998). This involves estimating the equation in differences with lagged values of the regressors as instruments (as in the DIF-GMM), as well as estimating the equation in levels with lagged differences of the regressors, with the order and number of lags being determined by our theoretical consideration of endogenous, predetermined and exogenous variables. These assumptions are tested by comparing different specifications and by using the Sargan test of over-identifying restrictions, which makes it possible to choose the best specification. In our table of results we will also present other tests required for this technique. These are the m1 and m2 Arellano and Bond statistics (Arellano & Bond, 1991), which test for negative first order autocorrelation and no second order autocorrelation. The estimations also include time dummies in order to control for changes in other variables not included in our model. A word of caution is needed when interpreting our regressions: GMM techniques perform better the larger the sample used, so there is some margin of error for shorter panels such as those of sectoral studies.

Tables 3a and 3b comprise the analysis of the effect of outsourcing on Spanish industrial employment taking into account the origin of goods and the characteristics of the buying industry. We first discuss the coefficients for the standard labour demand equation

regressors and then move to the discussion of our variable of interest: outsourcing. Results show consistent coefficients for added value, wages and lag of labour. All three coefficients are always statistically significant (except for one case) and remain approximately constant in all regressions - with values close to those found by previous empirical studies - except the ones in columns (4), (5) and (6), where there the number of sectors is reduced, as explained below, affecting the consistency of results.

In all cases, the choice of instruments in this regression is made according to the assumptions on the variables made by the model, based on economic theory and supported by results. The model assumptions are endogeneity for value added and labour, predetermination for wages and exogeneity for outsourcing. Different assumptions on the variables were tried but were not supported by results.

Columns (1), (2) and (3) show results for all industrial sectors. The outsourcing measure, even though it increases its value the more precise its geographical definition, is non-significant independently of the origin of goods. Since we expect changes in the outsourcing effects depending on sectoral characteristics, we re-estimate our regressions for two types of sectors: low-tech and medium and high-tech. Columns (4) to (6) reduce the original sample to 38 low-tech sectors, so the problem of a small dataset appears (see, for example, the Sargan coefficient) thus leading to differences in the value of coefficients. Low-tech sectors include those in which Spain has been historically specialised (*Textiles, Shoes, Food industries*, etc.) but still we observe that the outsourcing coefficient is non-significant.

Columns (7) to (9) consider 54 medium and high-tech sectors such as *Machinery, Equipment, Chemicals, Metallic products*, etc. In columns (7) to (9) we find that the outsourcing coefficient keeps its negative sign and becomes significant for goods brought from CEE countries and Turkey. Results show a negative effect on Spanish employment from outsourcing to Turkey and CEE countries. Outsourcing is oriented towards low-wage countries so that growing intra-industrial imports have a negative effect on the outsourcer's employment. Firms move those stages of their production, which are intensive in non-qualified work to low-wage countries, in order that they reduce their costs, thereby improving their competitiveness.

To explain the non-significance of the global outsourcing measure we attend to the strategic nature of the outsourcing. Outsourcing can be considered as a strategic variable for firms, they change the origin of their imported intermediate inputs at short notice, in response to market conditions, which leads to changes in the value of outsourcing to different countries⁵⁰. This holds true for specific geographical outsourcing, such as those in columns (8) and (9), but changes in outsourcing origin cannot be evaluated by a general measure such as All countries outsourcing, in column (7).

We therefore conclude that the increasing medium and high intra-industrial imports have a negative effect on Spanish employment. The use of ITC and the reduction of trade barriers have allowed firms to restructure their production organisation within a global framework. This generates a substitution of domestic intra-industrial inputs by foreign ones. Outsourcing for medium and high technology sectors has increased dramatically for Turkey and CEE countries during the analysed period. In the case of outsourcing to CEE countries for medium and high-tech sectors it increased spectacularly from 1993-2003 (by more than 300%). In relation to imported intermediate inputs from Turkey there has been an increase together with a change in its composition. In previous periods *Mineral goods* and *Textiles* represent the majority of Spanish imports from Turkey, while medium and high tech products have increased their weight the most. As a result, in 2003, *Motor vehicles and components* and *Electronic goods* account for the 15% and 10% of Spanish imports from Turkey respectively

⁵⁰ Grossman & Helpman (2002, 2005) are good examples of theoretical models for these strategic decisions within a firm.

(2% and 5% in 1995). This change is the result of a deep transformation in Turkish production structure, analysed in previous literature such as Akgüngör & Falcioglu (2005) "...specialisation trend is towards middle level technology industries and ICT (information and communication technology) industries and away from labour and resource based low and middle tech industries" (pp. 14).

Table 3a Outsourcing effect, different groups of countries and types of sector, 1993-2003

	All sectors	All sectors	All sectors	Low-tech sectors	Low-tech sectors	Low-tech sectors	Medium and high-tech sectors	Medium and high-tech sectors	Medium and high-tech sectors
Variable	All countries	CEE countries	Turkey	All countries	CEE countries	Turkey	All countries	CEE countries	Turkey
L_{t-1}	0.72577 0.000***	0.72957 0.000***	0.70493 0.000***	0.56824 0.000***	0.52734 0.004***	0.53208 0.000***	0.83320 0.000***	0.83209 0.000***	0.73499 0.000***
$(Q-CI)_t$	0.27200 0.000***	0.27010 0.000***	0.29822 0.000***	0.46531 0.002***	0.51246 0.012**	0.42308 0.000***	0.18461 0.000***	0.20077 0.000***	0.31155 0.000***
GPH_t	-0.34758 0.000***	-0.33093 0.000***	-0.34943 0.000***	-0.42116 0.000***	-0.45224 0.000***	-0.53529 0.000***	-0.15205 0.171	-0.16294 0.067*	-0.27749 0.017**
Outsourcing _t	0.00184 0.901	-0.00599 0.639	-0.01143 0.450	-0.00520 0.856	0.00656 0.804	0.00399 0.877	-0.01964 0.152	-0.05846 0.006***	-0.04223 0.002***
Sargan test	67.63 [0.206]	65.85 [0.252]	67.77 [0.203]	20.99 [1.000]	20.89 [1.000]	25.91 [1.000]	51.46 [0.747]	46.96 [0.871]	45.58 [0.900]
m (1)	-4.043 [0.000] **	-4.027 [0.000] **	-3.908 [0.000] **	-1.812 [0.070]	-1.750 [0.080]	-1.872 [0.061]	-4.833 [0.000] **	-4.865 [0.000] **	-4.690 [0.000] **
m (2)	1.870 [0.061]	1.865 [0.062]	1.803 [0.071]	1.282 [0.200]	1.268 [0.205]	1.297 [0.195]	2.004 [0.045] *	1.988 [0.047] *	1.702 [0.089]

1. GMM-SYS estimates. All variables in logs. Estimations are run using DPD for PcGive. The table shows 2-step estimators, using finite sample corrected standard errors.

2. Test: p values for significance of coefficients, null hypothesis for Sargan, and autocorrelation tests m (1) and m (2). * indicates significance at 10% level, ** at 5% level and *** at 1% level.

3. Estimation includes NACE 151-223, excluding 160, and 361-366 for low-tech sectors, and NACE 241-355 for medium-high-tech sectors.

Instruments: Transformed equation: $L_{i,t-2}$, $(Q-CI)_{i,t-2}$, $W_{i,t-1}$, $W_{i,t}$, Outsourcing_{it}

Level equation: time dummies, $\Delta L_{i,t-1}$ and $\Delta (Q-CI)_{i,t-1}$.

Table 3b Outsourcing effect, long-run coefficients

	All sectors	All sectors	All sectors	Low-tech sectors	Low-tech sectors	Low-tech sectors	Medium and high-tech sectors	Medium and high-tech sectors	Medium and high-tech sectors
Variable	All countries	CEE countries	Turkey	All countries	CEE countries	Turkey	All countries	CEE countries	Turkey
$(Q-CI)_t$	0.99187	0.99878	1.01067	1.07771	1.08420	0.90418	1.10678	1.19570	1.17561
GPH_t	-1.26748	-1.22372	-1.18422	-0.97545	-0.95680	-1.14398	-0.91160	-0.97041	-1.04708
Outsourcing _t	0.00671	-0.02215	-0.03874	-0.01204	0.01388	0.00853	-0.11772	-0.34815	-0.15935

The different effects found in our results for low and medium and high-tech sectors can be easily explained by attending to three factors: 1) Imports of low-tech products are mainly final goods, while imports from medium and high-tech sectors are mostly intermediate and capital goods; 2) Spain is more competitive in low-tech products (between 1995 and 2001 Spanish low-tech industry value added and labour grew well over the EU-11 rate, and their exports and R&D expenditure grew faster than in these areas for medium and high tech industry, as described by Gandoy & González, 2004); and 3) Multinational firms, the leading agents of outsourcing, are far more important in medium and high-tech sectors (as shown by Torrent & Gual, 2005).

This is consistent with previous literature, such as Egger et al. (2003), which concludes that outsourcing and imports negatively affect employment in sectors with a comparative disadvantage, such as medium and high-tech sectors in Spain. A negative impact on low-tech employment such as that found by Falk & Wolfmayr (2005) is only apparently different, as their study focuses on northern EU countries which are competitive in medium and high-tech products. There are no studies, to the best of our knowledge, on the effect of Turkish imports on employment or productivity for any country.

The validity of the instruments for table 1, columns (8) and (9), is not rejected by the Sargan test of over-identifying restrictions. The results of the second order serial correlation tests (negative correlation in m1 and no correlation in m2) are marginally consistent with the assumption of no serial correlation in the residuals.

Deeper investigation has been performed into the consistency of the regressions and the adequacy of the estimation technique. We proceed to comment on the results (not shown but available on request). OLS, within group and GMM differences regressions were estimated.

Previous literature demonstrates that, relative to GMM, OLS biases $\hat{\alpha}_0$ (the estimated coefficient for the lagged employment) upwards, while within group biases $\hat{\alpha}_0$ downwards (see Arellano & Bond, 1998). These expected results were confirmed with a very high coefficient for lagged labour in the OLS regression (0.99) and a low coefficient in the within regression (0.74). First-differenced GMM, which estimates an equation in differences using instruments in levels, shows an estimator for lagged employment below the within group estimator, so that a problem of weak instrument exists. This problem is partially overcome by using system GMM as the validity of the extra information in the system GMM is not rejected by the Sargan test. As stated before, results for the second order serial correlation tests are consistent with the assumption of no serial correlation in the residuals at the 5% level. The similarity between the SYS-GMM estimators and the within group one shows that there is a short panel problem.

Concluding remarks

Spanish manufacturing industries are involved in a delocalisation process on a worldwide scale, by which firms located in developed countries import an increasing share of their intermediate inputs mainly from low-wages countries. They do so either by locating part of their production in those countries or by choosing the best provider in the world. Studying this process by country and sector is essential in order to understand it. Our results show that, by country, although imported inputs to Spain are growing for almost all countries of origin, they are increasing much faster for low-wage countries (Asia, CEE, Turkey, etc.). Furthermore, this phenomenon spans all of the manufacturing industries, as narrow outsourcing and vertical specialisation measures for low-wage countries evolve significantly for most sectors. Nevertheless, this process is more intense in high-tech industries related to ICT, in *Motor*

vehicles (a sector of specialisation for Spain) and also in some traditional Spanish industries (*Textiles, Paper and paperboard, Wood and cork, and Leather and shoes*).

Although the characteristics of production in each industry explain its outsourcing, our results show deficiencies in the Spanish productive structure. Firstly, the Spanish economy is forced to import capital and ICT goods, both as final and intermediate products, as a result of the reduced weight of domestic production. Secondly, foreign capital is predominant, mainly through multinationals' location, in high technology firms (due to their location strategies in the past). These multinationals only locate part of the production process in Spain and therefore they need to import a great amount of intermediate inputs. Thirdly, these sectors favour the outsourcing process by focusing on product differentiation, introducing information and communication technologies to a greater extent and allowing a greater vertical fragmentation. Our results, therefore, show that outsourcing to CEE countries and Turkey has a negative impact on employment in Spanish medium and high-tech manufacturing industries, while it has no effect on the economy as a whole. The manufacturing sector is increasingly moving some production stages to low-wage countries, relocating employment that was previously generated domestically.

Outsourcing in the traditional (low-tech) industry is less important and particularly directed to low-wage countries. We have not found any effect from outsourcing to Turkey, CEE countries or the world economy on employment in traditional low-tech manufacturing industries. This outsourcing has been led by some Spanish enterprises, such as Inditex, Mango, Camper, Famosa, Campofrío, Freixenet, Pescanova, etc., which use this chance to compete in a globalised economy, thereby increasing their market share in the EU as well as their own employment.

As we have seen in this study, outsourcing represents some risks for developed countries, e.g. the job losses generated by firms that delocalise, but they also favour some positive aspects as it becomes a strategy to increase firms' competitiveness in a globalised environment. The manufacturing firms largely outsource labour-intensive activities to low-wages countries, whilst keeping value-added activities in Spain (design, research, marketing, etc.). Furthermore, the profits these firms generate are returned to Spain manifold through capital flows and skilled high-wage activities in the country. In any case, we find it advisable to implement structural and labour policies to allow those workers, industries and regions that are intensively disadvantaged to adapt to this new economic and job context.

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Appendix I

Industry list – Low-tech and medium and high-tech sectors

Low-tech sectors
NACE 151. Meat industry
NACE 152. Production and preserving of fish and fish products
NACE 153. Processing and preserving of fruit and vegetables
NACE 154. Manufacture of fats and oils (vegetal and animal)
NACE 155. Dairy industries
NACE 156. Milling, starch and cereal products
NACE 157. Products for animal food
NACE 1581, 1582. Bread, biscuits, pastry goods and cakes
NACE 1583, 1584. Manufacture of sugar, cocoa and chocolate
NACE 1585, 1586, 1587, 1588, 1589. Other food products
NACE 1591, 1592, 1593, 1594, 1595, 1596, 1597. Production of alcoholic beverages
NACE 1598. Production of mineral waters and non-alcoholic beverages
NACE 171. Preparation and spinning of textile fibres
NACE 172. Textile weaving
NACE 173. Textile finishings
NACE 174. Other made-up textile articles, except apparel
NACE 175. Other textile industries
NACE 176. Manufacture of knitted and crocheted fabrics
NACE 177. Manufacture of knitted and crocheted articles
NACE 181, 182. Manufacture of wearing apparel
NACE 183. Fur industry
NACE 191. Tanning and dressing of leather
NACE 192. Leather goods, luggage, saddlery and harness
NACE 193. Manufacture of footwear
NACE 201. Sawmilling, planing and industrial preparation of wood
NACE 202. Manufacture of veneer sheets; plywood, laminboard, fibre board and other panels and boards
NACE 203. Manufacture of builders' carpentry and joinery
NACE 204. Manufacture of wooden containers
NACE 2051. Manufacture of other products of wood
NACE 2052. Manufacture of cork, straw and plaiting materials
NACE 211. Manufacture of pulp, paper and cardboard
NACE 212. Manufacture of articles of paper and cardboard
NACE 221. Publishing
NACE 222, 223. Graphic arts and reproduction of recorded media
NACE 361. Manufacture of furniture
NACE 362. Manufacture of jewellery and related articles
NACE 364, 365. Manufacture of sports goods, games and toys
NACE 363, 366. Various other manufacturing industries
Medium and high-tech sectors
NACE 241. Manufacture of basic chemical products
NACE 242. Manufacture of pesticides and other agro-chemical products
NACE 243. Paints, varnishes, printing ink and mastics
NACE 244. Manufacture of pharmaceutical products
NACE 245. Manufacture of cleaning and polishing preparations, toilet preparations
NACE 246. Manufacture of other chemical products
NACE 247. Manufacture of man-made fibres
NACE 251. Manufacture of rubber products
NACE 252. Manufacture of plastic products
NACE 261. Manufacture of glass and glass products

NACE 262. Ceramic goods other than for construction purposes
 NACE 263, 264. Ceramic tiles, slabs, bricks, roofing tiles and construction products in baked clay
 NACE 265. Manufacture of cement, lime and plaster
 NACE 266. Manufacture of articles of concrete, plaster and cement
 NACE 267. Cutting, shaping and finishing of stone
 NACE 268. Various non-metallic ore products
 NACE 271. Manufacture of basic iron and steel and of ferro-alloys ECSC
 NACE 272. Manufacture of tubes
 NACE 273. Other first processing of iron and steel
 NACE 274. Manufacture and first processing of basic precious and non-ferrous metals
 NACE 275. Casting of metals
 NACE 2811. Manufacture of metal structures and parts of structures
 NACE 2812. Manufacture of builders' carpentry and joinery of metal
 NACE 282. Manufacture of tanks, large deposits & metal containers; central heating radiators & boilers
 NACE 283. Manufacture of steam generators
 NACE 284. Forging, embossing and drawing of metals; dust metallurgy
 NACE 2851. Treatment and coating of metals
 NACE 2852. General mechanical engineering
 NACE 286. Manufacture of cutlery, tools and general hardware
 NACE 287. Manufacture of other fabricated metal products, except furniture
 NACE 291. Manufacture of machinery and mechanical equipment
 NACE 292. Manufacture of other general purpose machinery, equipment and mechanical material
 NACE 293. Manufacture of agricultural and forestry machinery
 NACE 294. Manufacture of machine-tools
 NACE 295, 296. Manufacture of miscellaneous special purpose machinery. Manufacture of weapons & ammunition
 NACE 297. Manufacture of household appliances
 NACE 300. Manufacture of office machines and computers
 NACE 311. Manufacture of electric motors, generators and transformers
 NACE 312. Manufacture of electricity distribution and control apparatus
 NACE 313. Manufacture of insulated wire and cable
 NACE 315. Manufacture of electric lamps and lighting equipment
 NACE 314, 316. Manufacture of accumulators, primary cells primary batteries and other electrical equipment
 NACE 321. Manufacture of electronic valves and tubes and other electronic components
 NACE 322. Manufacture of television and radio transmitters and apparatus for line telephony and line telegraphy
 NACE 323. Manufacture of TV & radio receivers, sound/video recording, reproducing apparatus & associated goods
 NACE 331. Manufacture of medical and surgical equipment and instruments and other orthopaedic appliances
 NACE 332, 333, 334, 335. Measuring, control, optical and photographic appliances
 NACE 341. Manufacture of motor vehicles
 NACE 342. Manufacture of bodies coachwork for motor vehicles; trailers and semi-trailers
 NACE 343. Parts and accessories for motor vehicles and their engines
 NACE 351. Building and repairing of ships and boats
 NACE 352. Manufacture of railway and tramway locomotives and rolling stock
 NACE 353. Manufacture of aircraft and spacecraft
 NACE 354, 355. Manufacture of motorcycles, bicycles and other transport equipment

Section 3

Implications and determinants of FDI in Central and Eastern Europe

Foreign direct investment in new EU Member States

Magdalena Kisielewska⁵¹
Grażyna Kozuń – Cieślak⁵²

Abstract

Dynamic globalisation of the world economy has intensified the circulation of capital in the form of foreign direct investment. Direct investment is not, however, only a simple transfer of capital but it involves also transfers of: technology, know-how, and knowledge within management and organisation of work, as well as the linking to international distribution channels. This specific form of attracting capital to the host country contributes to the modernisation of the economy and improvement of its competitiveness. We can say therefore that *Foreign Direct Investment* (FDI) is a certain object of competition, especially among developing countries. We should bear in mind, however, that success in attracting FDI is not synonymous with the host country's declarations that it is ready to absorb it but it depends on various political, economic and social factors which make up a holistic evaluation of investment attractiveness of the host country.

The aim of the paper is to identify the leaders in attracting FDI among new EU member states and to compare their investment attractiveness.

The following hypotheses are subject to verification:

1. The years 1990-2004 are a period of intensive inflows of FDI to the countries which joined the European Union in 2004 but in spite of that, those countries still play an insignificant part in absorption of the world FDI inflows.
2. Allocation of FDI within the analysed group of countries is deeply uneven but the ranking of leaders is rather ambiguous.
3. High investment attractiveness of the analysed group of countries as well as institutional and legal implications of joining the EU encourage higher significance of those economies in attracting foreign capital.

⁵¹ m.kisielewska@univ.szczecin.pl

⁵² grazyna.cieslak@interia.pl

Definitions and methodology

Research object: foreign direct investment

OECD recommends that a **direct investment enterprise** be defined as an incorporated or unincorporated enterprise in which a foreign investor owns 10 per cent or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise. The numerical guideline of ownership of 10 per cent of ordinary shares or voting stock determines the existence of a direct investment relationship. An effective voice in the management, as evidenced by an ownership of at least 10 per cent, implies that the direct investor is able to influence or participate in the management of an enterprise; it does not require absolute control by the foreign investor (OECD benchmark definition of foreign direct investment 1999: p. 8).

According to the definition adopted by UNCTAD:

Foreign Direct Investment (FDI) inflows comprise the capital provided (either directly or through other related enterprises) by a foreign direct investor to an FDI enterprise, or the capital received by a foreign direct investor from an FDI enterprise. FDI includes the three following components:

1. **Equity capital** is the foreign direct investor's purchase of shares of an enterprise in a country other than that of its residence.
2. **Reinvested earnings** comprise the direct investor's share (in proportion to direct equity participation) of earnings not distributed as dividends by affiliates or earnings not remitted to the direct investor. Such retained profits by affiliates are reinvested.
3. **Intra-company loans** or **Intra-company debt transactions** refer to short- or long-term borrowing and lending of funds between direct investors (parent enterprises) and affiliate enterprises.intra-company loans.

FDI stock is the value of the share of their capital and reserves (including retained profits) attributable to the parent enterprise, plus the net indebtedness of affiliates to the parent enterprises.⁵³

Sources of statistical data

Data provided by the United Nations Conference on Trade and Development (APPENDIX, Tables A5, A6 in the Appendix). Nominal figures have been converted into real ones by means of appropriate conversion factors (to convert dollars of any year to dollars of the year 2004, one should divide the dollar amount from that year by the *conversion factor* (CF) for that year):

Table 1 Conversion Factors for Dollars 1990 to estimated 2004

Year	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
CF	0.692	0.721	0.743	0.765	0.785	0.807	0.831	0.850	0.863	0.882	0.912	0.938	0.952	0.974	1.000

Source: R. Sahr: *Inflation Conversion Factors for Dollars 1665 to Estimated 2016*. Oregon State University: http://oregonstate.edu/dept/pol_sci/fac/sahr/sahr.htm (30.05.2006)

Research scope

The research focuses on 10 countries which joined the European Union in 2004 (Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia) and

⁵³ For more details see UNCTAD home page: <http://www.unctad.org>

multinational units: EU-15 economies, developed economies, world (according to UNCTAD classification).

Time range: years 1990 - 2004

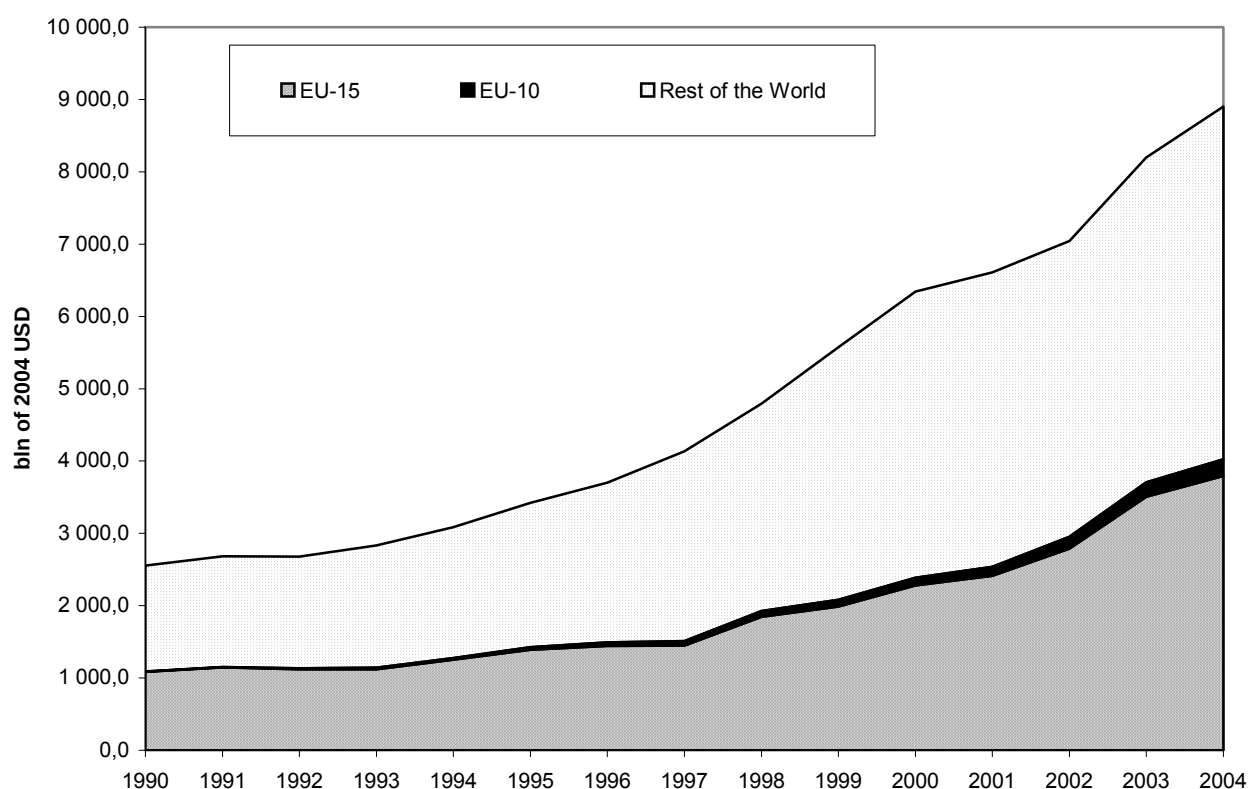
Methodology

- quantitative analysis (dynamics, structure) of the amount of FDI (expressed in FDI inward stock and FDI inflows) allocated in selected groups of countries,
- comparative analysis of the factors which indicate significance of FDI to host countries and investment attractiveness indices in the analysed group of countries.

Allocation of FDI in the world in 1990-2004

In the years 1990-2004 we were witnessing an intensive growth in the global FDI (See: Figure 1 below and Table A5 in the Appendix). Within this period the world FDI inward stock increased from 2.6 billion USD to 8.9 billion USD. The greatest share of FDI – ranging from 67% to 80% - was concentrated in developed countries, and most of it, 52%-59%, was allocated in the EU-15 member countries.

Figure 1 Foreign direct investment inward stock in 1990 – 2004



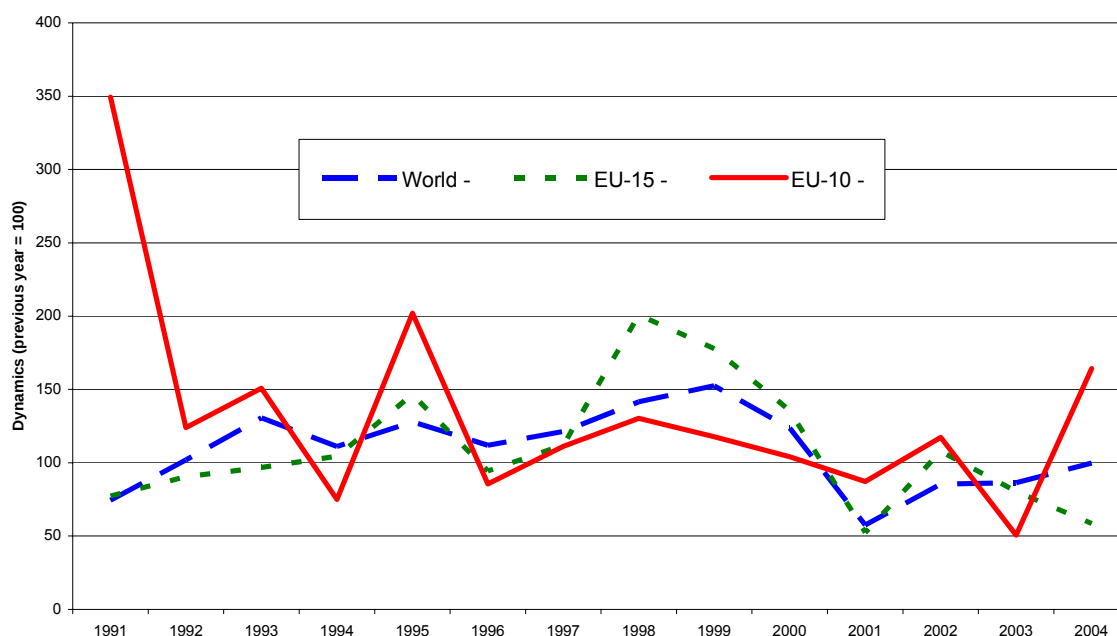
Over the analysed fifteen years, the world FDI inward stock more than tripled in real terms (See: Table A5 in the Appendix). A similar growth rate was observed for EU-15 countries. The most dramatic rise was reported in the countries which joined the European Union in 2004. Total FDI inward stock in those economies in 1990 amounted to only 2.5 billion USD to rise to as much as 229.7 billion USD in 2004 (which meant a huge, 60-fold increase in real

terms). Nevertheless, the investors' interest in the CEEC does not imply the region was the leader in attracting FDI. At the end of the analysed period, the EU-10 FDI inward stock represented only 6% of the EU-15's and as little as 2.6% of the global FDI inward stock (See: Table A1 in the Appendix).

It should be stressed that the transition in the CEEC aroused more interest in those countries as attractive in terms of long-term investment (whereas in 1990 those countries accounted for only 0.1% of the world FDI inward stock).

As far as the annual FDI inflows are concerned (See: Figure 2 below and Table A2 in the Appendix), in 1992-2000 they were increasing for the world economy at a dynamic rate (in 1998 and 1999 even by 40%-50% as compared to the preceding year). A similar situation can be observed for developed countries – from 1993 on, the annual FDI inflow was constantly rising – in 1998 and 1999 even by 75% and 65%, respectively. In 2001, however, the trend reversed and we were witnessing annual declines in FDI inflows both in the world and in the group of developed countries. In the whole analysed period, the developed economies attracted from 58% to 83% of the world FDI inflows.

Figure 2 FDI inflows dynamics



EU countries, on the other hand, attracted foreign capital in the form of FDI with varying success. At the beginning of the period, in 1991-1993, their FDI inflow decreased annually, yet the dynamics of that fall was weaker and weaker to reverse this trend in 1997-2000 when an intensive growth in the figure was recorded (i.e. 12%, 100%, 78% and 36%, respectively). Then a period of dramatic decline of FDI inflows followed, with a nearly 50% fall in 2001, 20% in 2003 and 40% in 2004. The EU-15 countries accounted for 27% to 56% of the world annual FDI inflow over the whole analysed period.

In the group of new EU-10 member states, at the beginning of the analysed period, the dynamics of the FDI inflow increase was relatively high (in 1991-1993 the following growth rates were observed: 250%, 24% and 50%). After this boom, a year later a 25% decline was recorded. The following years brought again a 100% growth (1995) and then a 25% fall (1996), as compared to the preceding year. Next, from 1997 to 2000, FDI inflow was constantly increasing every year.

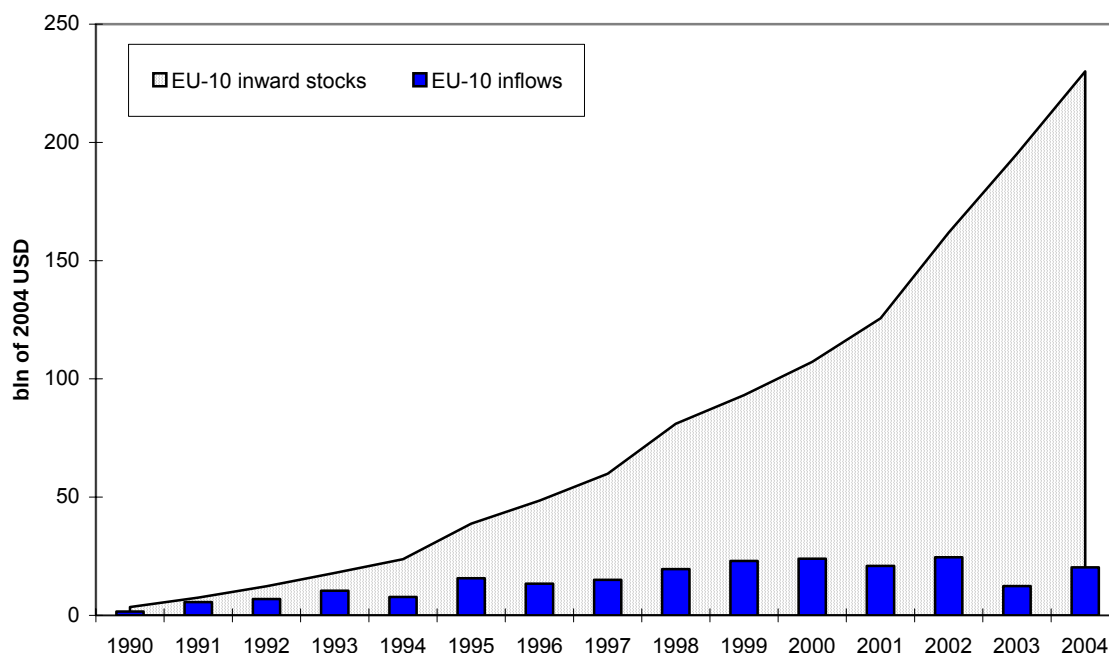
The highest relative FDI inflow in this group of economies was recorded in 1995 when it accounted for 3.7% of the world FDI inflow (in the remaining years the share ranged from 0.5% to 3.5%). In 2001 total FDI inflow to EU-10 countries fell but the fall was less significant than for the world as a whole or for the other analysed groups of countries. The following years brought growths and falls in turn. A huge (over 60% growth) was recorded in 2004, i.e. the year of accession, and it can be explained with higher credibility of the new EU member states to investors. It should also be stressed that in this year in all the other groups of countries the FDI inflow fell (in EU-15 countries by as much as 47%). But in spite of that fall, total FDI inflow in new member states in 2004 represented only 10% of the figure reported for the EU-15 countries (i.e. 20.3 billion USD for EU-10 compared to 196.1 billion USD for EU-15). See Table A2 in the Appendix for details.

FDI in new EU member states in 1990 - 2004

Eight out of ten countries which joined the European Union in 2004 were post-socialist CEEC. Their system transformation – started in the early 1990s – resulted, among others, in the introduction of various legal regulations which liberalised financial markets, and brought them closer to the solutions adopted in the OECD countries. The principle of “*national treatment*” of foreign investors had initiated a period of intensive inflow of foreign capital in the form of FDI and so FDI became an object of competition among post-socialist countries on the one hand, and on the other – a new destination for the world capital flows searching for the most attractive allocations.

In the analysed period, total FDI inward stock attracted by ten new EU member states increased in real terms more than 65 times (from 3.5 billion USD in 1990 to 230 billion USD in 2004). In the same period, the average annual FDI inflow reached 13.3 billion USD (with the lowest figure for 1990 – 1.6 billion USD, and the highest for 2002 – 24.5 billion). Detailed data for EU-10 countries is provided in Tables A3 and A4 in the Appendix. And Figure 3 below presents overall stock and inflow data for new member states.

Figure 3 EU-10 FDI inward stock and inflows in 1990-2004



It should be stressed, however, that the distribution of the investment was dramatically uneven. Only three countries – the Czech Republic, Poland and Hungary – attracted as much as 78-85% of FDI in the analysed period. The leader in attracting foreign investment in 1990-1995 was Hungary – with its 37-74% of the annual FDI inflow oriented at the EU-10. In the years 1996-2004 (excl. 2002) it was Poland, being a destination for 29-40% FDI, that became the new leader in attracting FDI. According to the end-2004 data, the three countries mentioned above accounted for 24.6-26.7% of total FDI inward stock allocated in EU-10. This relatively even share in total FDI targeted at EU-10 countries does not imply their equal position if differences in terms of e.g. population are taken into account (See: Table A3 in the Appendix). In Poland the *per capita* FDI inward stock was much lower than in the Czech Republic or Hungary. In 1998-2004 the figures for those countries were 2.5-3.5 times higher than in Poland, and at the beginning of the analysed period the disproportion was much greater. From this perspective, countries like Malta, Cyprus or Estonia – economies which attracted annually only several per cent of the annual FDI inflow targeted at EU-10 over the last ten years (Cyprus: 2.1-8.4%; Estonia: 1.2-7.4%; Malta 0.6-4.3%) – become leaders in the new *per capita* ranking. In those countries the *per capita* FDI inward stock is much above the average for EU-10 whereas in Poland the figure is much below that average and belongs to the lowest in the group – next to Lithuania and Latvia. In the last year of the analysed period, the EU-10 average of *per capita* FDI inward stock amounted to 3,079 USD; the lowest amount was reported for Poland (only 1,593 USD) and the highest – for Cyprus (nearly 10,000 USD) and Malta (8,897 USD).

It should also be noted that the EU-10 average of *per capita* FDI inward stock is still much lower than in the EU-15 countries. Over the last nine years, the analysed figure was 3 to 5 times higher in the “old” EU members than the average for new member states, the differences being much greater at the beginning of the analysed period.

As far as dynamics of annual FDI inflows to the analysed EU-10 countries is concerned, big differences could be observed over the whole period in question (See: Table A4 in the Appendix). The highest increase in the FDI inflow as compared to the preceding year was observed in 1991 at the level of 250%; in 1995 it was 102%, and in the remaining years ranged from 4% to 50%. The greatest decline, on the other hand, was recorded in 2003 at

the level of 50%. In that year only two countries – Estonia and Hungary – did not report falls. It should also be noted that Malta is the only country which in the analysed period reported a negative dynamics of FDI inflow (a 262% fall in 2002 and a 167% fall in 2003 as compared to the preceding year). It should also be mentioned that in 2004 all the new EU member states reported an increase in the FDI inflow (although with various intensity: the highest figure for Lithuania – a 320% growth and the lowest for Estonia – 1.2%), whereas the falling tendency observed for the whole world and the group of developed countries since 2001 continued. The situation can be explained with increased investment attractiveness of and investors' confidence in the post-socialist countries after their accession to the European Union.

EU accession – opening balance of FDI in the new member countries

Inward FDI stock in the 10 new EU member countries at the end of 2004 reached 230 billion USD. In terms of *per capita* it was 3 079 USD, which is three times below the EU-15 average. Moreover, in five out of ten analysed countries, the *per capita* FDI inward stock was much below the EU-10 average (Slovakia, Slovenia, Latvia, Lithuania, Poland).

FDI inflows into the 10 EU-accession countries rose by 64% in 2004, to \$20.3 billion, with Poland, the Czech Republic and Hungary, in that order, receiving the largest FDI inflows. Reinvested earnings accounted for more than half of the FDI flows to these countries, whereas equity investments in new projects and privatization sales were the dominant forms of FDI in Slovakia, Latvia and Lithuania. Such *inflows of FDI* to the EU-10 countries, expressed *per capita*, reached on average 273 USD, yet the disproportions between the countries were relatively high: from 160 USD (Poland) to 1,388 USD (Cyprus). In the EU-15 countries the level of *per capita* FDI inflows reached 511 USD, which is more than in almost all CEEC (except for Estonia).

Interesting tendency can also be observed in the *per capita FDI inward stock per sq. km of area*. Peculiar seems to be the situation of Malta, where nearly 11.9 million USD of foreign capital was invested into 1 sq. km on average. In the other countries the figure does not even reach 1 million USD. The lowest value was recorded in Latvia (0.07 million USD), and the highest in Cyprus (0.87 million USD), which along with the Czech Republic and Hungary leaves the other EU-10 countries far behind. In spite of that, FDI inward stock per sq. km in those countries was below the EU-15 average, amounting to 1.29 million USD.

On the other hand, if *FDI inward stock as percentage of GDP* is compared, most of the new member countries reported indices above the EU-15 average, the latter reaching 31% in 2004. In the case of five countries, this ratio exceeded 50% (in Estonia it was even 85%), and only in three of them it remained below the EU average (Slovenia – 15%, Poland – 25%, Lithuania – 29%).

Table 2 Foreign direct investment in new EU member countries in 2004 – selected indices

ECONOMY	FDI inward stock	FDI inflows	FDI inward stock		FDI inflows as percentage of		
	<i>per capita</i> (USD)		per sq. km (mln USD)	as percentage of GDP	gross fixed capital formation	exports	imports
UE-15	9 891	511	1.29	31.3	8.4	6	6
Cyprus	9 847	1 388	0.87	52.7	40.2	99	20
Czech Rep.	5 515	436	0.72	52.7	15.4	7	6
Estonia	7 138	694	0.21	85.1	29.6	16	11
Hungary	5 959	412	0.65	60.7	18.6	8	7
Latvia	1 938	279	0.07	32.9	16.7	17	9
Lithuania	1 855	225	0.10	28.8	15.8	8	6
Malta	8 897	1 053	11.86	66	37	16	11
Poland	1 593	160	0.20	25.4	14.5	8	7
Slovakia	2 685	208	0.30	35.3	11.1	4	5
Slovenia	2 522	262	0.24	15.1	6.5	3	3

Source: Compiled on the basis of UNCTAD data – *Handbook of Statistics On-Line* (<http://www.unctad.org>)

The *FDI/GDP index* is one of four elements used to calculate the so-called *Transnationality Index*⁵⁴. That index attempts to measure the transnationalization of economic activity of host countries in real terms, taking into consideration both the production potential created through inward FDI and the results of this investment. The other three elements include: FDI inflows as a percentage of gross fixed capital formation (GFCF), value added of foreign affiliates as a percentage of GDP; and employment of foreign affiliates as a percentage of total employment. The simple average of these four shares results in the *Transnationality Index* of a host country.

The first two shares indicate the importance of inward FDI flows and stocks in an economy. A larger capital base - corresponding to larger FDI - indicates the potential to produce more. The last two shares capture the significance of foreign affiliates. The two sets of variables are correlated: high FDI shares are normally reflected in more activities by foreign affiliates in a country (World Investment Report 2002: p. 20) .

According to the data of 2004, in all the new EU member states (except for Slovenia) the ratio of FDI to gross fixed capital formation (GFCF) exceeded the EU-15 average (8.4%). The higher the ratio, the more the economy is dependent on foreign capital, or – in other words – the weaker the investing capacity of the national capital. Huge relevance of foreign capital, measured with the FDI/GFCF ratio, is reported in Cyprus, Malta and Estonia – their share of FDI in total gross fixed capital formation reached 40-30%. In the other countries, the ratio ranges from 6.5% (Slovenia) to 18.6% (Hungary).

Unlike in the early stages of the world economy development, when the development of trade encouraged migration of people, capital and technology – the cause and effect reversed; at the moment it is migration of basic production factors that creates and accelerates foreign trade in individual countries. Moreover, theoretical research and various empirical analyses indicate clearly that the highest advantages of the participation in the global division of labour can be achieved in the conditions of parallel development of external trade relationships and foreign exchange of labour force, capital and technology (Misala 2006: p. 343).

⁵⁴ According to the data of 2002, the world's most transnational host economy is Hong Kong (81.6%), followed by Belgium and Luxembourg (77.1%), Ireland (69.3%), Singapore (60.3%), Trinidad and Tobago (51.2%). For new EU member states the indices ranged from 16% (Poland) to 39% (Estonia), whereas in the EU-15 they ranged from 6% (Italy) to 38% (Netherlands). (See: World Investment Report 2005: p. 16).

Contemporary research on the relationship between FDI and foreign trade stresses more and more often the complementarity of the analysed factors, both to the exports and imports, and their positive correlation (Majewska & Grala 2003: p. 445).

In this context, it should be stressed that the share of EU-10 countries is still insignificant both in the world FDI inward stock, with the level of 2.6%, and in the international trade – with a 3% share in the world imports and a 2% share in the global exports⁵⁵.

According to UNCTAD data, in 2004 total FDI inflows related to the export inflows in EU-10 ranged from 3% (Slovenia) to 17% (Latvia) in all the countries except for Cyprus where the index was much higher (99%). In most of the countries the index did not exceed 10%, however. Similar tendency can be observed for imports – in most of the analysed countries, FDI accounted for less than 10% of imports, the situation being relatively similar to the tendencies observed in the EU-15 and other developed countries. In the analysed year, the EU-15 average was 6% for both FDI/exports and FDI/imports indices, yet huge differences could be observed for individual countries. In Denmark, for instance, the ratios were negative (as a result of negative FDI) and amounted to minus 14% and minus 16% for exports and imports, respectively, whereas for Luxembourg the ratios reached 468% and 341%, respectively. As a comparison, the indices in question in other selected developed economies reached: Canada – 2% and 2%; USA – 12% and 6%; Japan – 1% and 2%, Australia – 49% and 39%; Norway – 3% and 4%; Switzerland – 4% and 4%.

It should also be mentioned that as in the past, the EU-15 countries were the major investors in the **10 new EU countries**. A recent study shows that the **largest investors** in these countries were *Germany* and *the Netherlands*, which together accounted for 40% of the inward stock, followed by *Austria* and *France*. It should also be noted that a significant share of FDI flows to the new countries is undertaken by foreign affiliates operating in the EU-15 (World Investment Report 2005: p. 84).

According to UNCTAD, there are three main trends emerging in FDI inflows to the new EU countries (World Investment Report 2005: pp. 86-87):

- New EU member states are increasingly attracting FDI into activities that require higher skills such as precision engineering, design and R&D. This quite often involves upgrading existing facilities and focusing on export-oriented manufacturing, particularly in the automotive and machinery industries.
- Small and medium-sized enterprises from the EU- 15 are beginning to invest in the new EU member countries. Prior to 2004, these companies were discouraged from investing in these countries because of the political and economic risks, and because stringent border controls made just-in-time delivery impossible. These obstacles have diminished since May 2004.
- Consolidation of some industries and restructuring of certain TNC (Trans National Companies) operations are taking place in the new EU member countries.

Attractiveness of new EU member countries to FDI as evaluated by UNCTAD

A country's attractiveness to foreign direct investment is decided by many factors that can be divided into three groups (World Investment Report 2002: p. 24)⁵⁶:

1. **Policy framework for FDI:** economic, political and social stability; rules regarding entry and operations; standards of treatment of foreign affiliates; policies on functioning and structure of markets; international agreements on FDI; privatization policy; trade policy and coherence of FDI and trade policies; tax policy.

⁵⁵ Own study based on Central Statistical Office data, www.gus.gov.pl

⁵⁶ On factors influencing a country's attractiveness to investment see also: Bojar 2001: pp. 23 – 24; Olesinski 1998: pp. 40 – 51.

2. Economic determinants:

- **market – seeking FDI:** market size and *per capita* income; market growth; access to regional and global markets; country – specific consumer preferences;
- **resource/asset – seeking FDI:** raw materials, low – cost unskilled labour; technological, innovatory and other created assets (e.g. brand names), including as embodied in individuals, firms and clusters; physical infrastructure;
- **efficiency – seeking FDI:** cost of resources and assets listed under resource/asset – seeking FDI, adjusted for productivity of labour resources; other input costs, e.g. transport and communication costs to/from and within host economy and costs of other intermediate products; membership of a regional integration agreement conducive to the establishment of regional corporate networks;

3. Business facilitation:

investment promotion (including image-building and investment-generating activities and investment-facilitation services); investment incentives; hassle costs (related to corruption, administrative efficiency, etc.) and social amenities (bilingual schools, quality of life, etc.); after-investment services.

Since the factors deciding about a country's attractiveness to investment are so numerous and often immeasurable, it is very difficult to compare different economies with regard to their competitiveness in attracting foreign direct investment. UNCTAD in its reports uses two indices that allow for evaluating countries with regard to the already completed foreign investments as well as the perspectives for their inflow.

The first index (*FDI Performance Index*) shows the achieved FDI level in the country. It is a ratio of the given country's inward FDI in total value of foreign direct investment realized worldwide to the country's GDP share in the world product⁵⁷.

The second index (*FDI Potential Index*) is an average of the results obtained from appropriate calculations⁵⁸, comprising twelve factors (variables measured on the scale from 0 to 1) influencing the given country's potential in attracting foreign direct investment. The variables used for determining the above index in the period 2001 – 2003 were (World Investment Report 2002: p. 36):

- GDP *per capita*,
- the rate of growth of GDP,
- the share of exports in GDP,
- telecom infrastructure (the average of telephone lines per 1000 inhabitants and mobile phones per 1000 inhabitants)
- commercial energy use *per capita*,
- share of R&D expenditures in gross national income,
- the share of tertiary students in the population,
- country risk,
- exports of natural resources as a percentage of the world total,
- imports of parts and components of electronics and automobiles as a percentage of world total,
- exports in services as a percentage of the world total,

⁵⁷ $INDi = (FDIi / FDIw) : (GDPi / GDPw)$, where: $INDi$ – the Inward FDI Performance Index of the i -th country, $FDIi$ – FDI inflows in the i -th country, $FDIw$ – world FDI inflows, $GDPi$ – GDP in the i -th country, $GDPw$ – world GDP. Countries with an index value of one receive FDI exactly in line with their relative economic size. Countries with an index value greater than one attract more FDI than may be expected on the basis of relative GDP. They may have exceptionally welcoming regulatory regimes, be very well managed in macroeconomic terms, or have efficient and low-cost business environments. They may offer other competitive attractions: good growth prospects, ample and economical skilled labour, natural resources, good R&D capabilities, advanced infrastructure, efficient financial support or well-developed supplier clusters. Or they may have privileged access or a favorable location for exporting to large markets, or serve as entrepôt bases or tax havens, and so on. On the other hand, countries with index values below one may suffer from instability, poor policy design and implementation or competitive weaknesses in their economies (World Investment Report 2002: p. 34).

⁵⁸ $(Vi - Vmin) : (Vmax - Vmin)$, where: Vi – the value of a variable for the country i , $Vmin$ – the lowest value of the variable among the countries, $Vmax$ – the highest value of the variable among the countries. (World Investment Report 2002: p. 34).

- inward FDI stock as a percentage of the world total.

The above indices for new EU member countries have been compiled in table 3 below. The indices for economies at the head and at the end of the ranking have been included in the table for comparison.

Table 3 Assessment of emerging markets' attractiveness to investment according to the UNCTAD indices

Country	FDI Performance Index 2002 - 2004		FDI Potential Index 2001 - 2003	
	Score	Rank (among 140 countries)	Score (0 - 1)	Rank (among 140 countries)
Best index	23.839	1 Azerbaijan	0.659	1 USA
Worst index	- 3.996	140 Surinam	0.031	140 Congo
Cyprus	4.633	14	0.269	42
Czech Republic	3.070	28	0.268	39
Estonia	4.478	16	0.282	32
Hungary	2.087	46	0.267	40
Latvia	2.053	47	0.247	44
Lithuania	1.728	59	0.242	47
Malta	1.150	84	0.273	37
Poland	1.251	75	0.252	43
Slovakia	3.328	25	0.243	46
Slovenia	1.708	60	0.317	28

Source: Compiled on the basis of the UNCTAD data (<http://www.unctad.org>)

The highest *FDI Performance Index* in the analysed period 2002 – 2004 was 23.839 (Azerbaijan) and the lowest was –3.996 (Surinam). In terms of *FDI Performance Indices*, new EU member states were ranked between 14th and 84th position with their indices ranging from 4.633 for Cyprus to 1.150 for Malta. Four countries from the EU-10 group – Cyprus, Estonia, Slovakia and the Czech Republic – are much ahead of the others with regard to the value of the *FDI Performance Index*. Poland was listed next to the last place (1,251).

The highest *FDI Potential Index*, reaching 0.659, was reported for the USA whereas the lowest, 0.031, for Congo.

The new EU member countries were placed between 28th and 47th position in the ranking, with the best rank for Slovenia (0.317), followed by Estonia (0.282) and Malta (0.273). The worst *FDI Potential Index* was observed for Lithuania (0.242) and Slovakia (0.243). Poland was listed at number seven (0.252) among EU-10.

Comparing the rankings by the *Potential Index* with those of the *Performance Index* gives an indication of how each country performs against its potential. Countries in the world can be divided into the following four categories:

1. *front-runners* – countries with high FDI potential and performance;
2. *above potential* – countries with low FDI potential but strong FDI performance;
3. *below potential* – countries with high FDI potential but low FDI performance;
4. *under-performers* – countries with both low FDI potential and performance.

The data for this categorization are limited to 2003 (due to unavailability of the 2004 data for the *Potential Index*), the last year of the global FDI downturn period. As in past years, there are no significant changes in the first and last groups, with many developed and newly industrializing economies in the former and many least developed countries or poor developing countries in the latter. The second and third groups also include mostly the same countries as in the previous year. The question remains for the above-potential countries as

to how they can continue to sustain their FDI performance at levels comparable with those of the past while addressing structural problems. The concern for the below-potential countries, on the other hand, is how they could raise their FDI performance to match their potential (World Investment Report 2005: p. 21).

On the basis of the indices presented above, the new EU countries have been classified in four groups (See table 4 below). *Group I* are front-runners in attracting FDI, with the level of both indices above the average assessed for the group of 140 evaluated countries. Eight new EU member economies have been placed in this group, with the *FDI Performance Indices* ranking from 4.633 (Cyprus) to 1.708 (Slovenia) and the *FDI Potential Indices* from 0.317 (Slovenia) and 0.242 (Lithuania). To compare, in this group there are such countries as Belgium and Luxembourg, Finland, Ireland, Singapore, Switzerland, but also Bulgaria, Tunisia, Vietnam.

Table 4 Matrix of inward FDI performance and potential, 2001 – 2003 for EU-10

Index		FDI Performance Index	
		High	Low
FDI Potential Index	High	Group I Front – runners	Group II Below - potential
		Cyprus Czech Rep. Slovakia Slovenia	Estonia Hungary Latvia Lithuania
	Low	Group III Above – potential	Group IV Under - performers
		-	-

Source: Compiled on the basis of World Investment Report (2005).

Group II are the countries that do not make use of their potential. Two countries of the new EU members have been placed here together with many rich and highly developed economies that have shown a low level of the *FDI Performance Index*, for example due to their policy and a tradition of their economy's low dependence on foreign investment. Such countries as Japan and Italy belong here. Also the United States have been placed in this group, showing the nearly highest *FDI Potential Index* but exhibiting a low level of FDI inflow in relation to the size of their economy. For Poland and Malta that have been placed in this group, the *FDI Performance Index* amounted to 1.252 and 1.150, respectively, and the *FDI Potential Index* –0.252 and 0.273. This group includes also e.g. Argentina, Russia, Ukraine, Kuwait, United Kingdom.

Group III is a group of economies with a weak structure but a significant inflow of foreign capital. Most of this group is constituted by poor countries lacking an industrial base. This group includes e.g. Albania, Moldova, Romania, Peru, Zambia.

Group IV comprises poor countries that are not able to attain the expected share in the world FDI inflows due to economic or political reasons. This group includes e.g. Algeria, Egypt, India, Turkey, Venezuela.

None of the EU member countries was classified in group III or IV.

Conclusions and projections

Dynamic globalisation of the world economy and the constant strive for better efficiency of the economy have intensified the transnational circulation of capital in the form of foreign direct investment. The process was also favoured by the system transformation in the CEEC, as a result of which the economies opened to foreign investors.

Huge need for foreign capital, related to underdevelopment of national capital resources, and the essence of the mechanism of the market economy required, naturally, liberalisation of the law regulating foreign investment. The principle of “*national treatment*” of foreign investors as well as various other regulations liberalising financial markets have initiated a period of an intensive inflow of foreign capital in the form of FDI. In this way, FDI has become an object of competition among post-socialist countries on the one hand, and on the other – a new, possible destination for the world capital flows searching for the most attractive allocations.

On the basis of the research, the following conclusions can be reached:

1. In the analysed period, the world FDI inward stock more than tripled but the allocation of investment is deeply uneven – developed economies attract annually from 60% to 80% of the world FDI inward stock.
2. EU-15 countries are the leaders in attracting FDI – they are annually the destination for approx. 40% of the world FDI inflow, and host approx. 50% of the FDI inward stock invested in developed economies.
3. As a result of system transformation in the post-socialist countries, new FDI recipients have emerged – over the analysed period a nearly 60-fold growth in the FDI inward stock located in those countries could be observed, and in spite of that their role in attracting FDI remains insignificant (2-3% of the world FDI inflow).
4. EU accession of CEEC, Cyprus and Malta in 2004 gives hope for a more dynamic inflow of FDI to those countries.
5. It should be stressed, however, that FDI inflow to EU-10 countries in the analysed period was deeply uneven – nearly 80% of the investment in those countries was located in the Czech Republic, Poland and Hungary.
6. The leadership of the three countries in attracting FDI expressed as a share in the total amount of investment in EU-10 countries is not ambiguous if we consider the relative amounts:
 - the highest *per capita* FDI inward stock was reported in Cyprus, Malta and Estonia (Poland being the last in the ranking),
 - as far as *FDI inward stock per sq. km* is concerned, Malta leaves other countries far behind; next in the ranking are: Cyprus, the Czech Republic and Hungary,
 - if *FDI inflow as % of GDP* is compared, the first place in the ranking belongs to Estonia (85%), followed by Malta (66%) and Hungary (60%), Poland reports only a 25% share,
 - in terms of the *FDI/GFCF index* (i.e. the relevance of FDI to the total investment activity of the country), the leaders are: Cyprus, Malta and Estonia, which leave the other countries far behind,
 - the leader in terms of *FDI related to exports and imports* is Cyprus, far ahead of its direct followers: Latvia, Malta and Estonia.
7. The evidence for the above analyses is provided by the indices: *FDI Performance* and *FDI Potential*. In all EU-10 countries the former is greater than 1, which means that those economies attract more FDI than would be suggested by their size – but also here Cyprus and Estonia remain ahead of the other countries, followed directly by Slovakia and the Czech Republic. Malta and Poland are ranked as the last ones. As far as the *FDI Potential Index* (basing on the structural economic factors) is concerned, it is Slovakia that becomes the leader in attracting FDI, followed by Estonia, Malta and Cyprus.

To sum up the information delivered by the two indices, all the EU-10 countries except for Malta and Poland can be classified as *front-runners*, i.e. countries where both indices reached above-average values in the analysed population of 140 countries. Poland and Malta were classified as *below-potential* economies, i.e. countries which do not use their full potential to attract FDI.

The above remarks let us hope for further intensification of FDI inflow to EU-10 countries over the coming years, especially that the main motives of foreign investors to invest in the 10 new EU members remain similar to those of the pre-accession phase (World Investment Report 2005: pp.86 - 87):

- For market-seeking investors it is the strong economic growth of new EU member countries in 2004: their real GDP grew by 5.5%, more than double the EU-15 average; and their favourable growth prospects continue to be very attractive.
- For efficiency-seeking investors:
 - competitive unit labour costs are particularly important. In 2000, wages in the then-accession countries reached one-fifth of the level of the EU-15, while in productivity there was only a one-to- three difference. According to one estimate, average wages in new EU members in 2020 will still be 60% lower than the EU-15 average.
 - in the new EU member States, corporate taxes are lower than in the EU-15: rates were 20%, on average, for the former compared to 31% for the latter. However, a simple comparison of tax rates is not sufficient for assessing the relative tax burdens in each country. Other elements (such as the tax base, or specific tax regimes) need to be taken into account.

Additionally, full membership of the EU since May 2004 means:

- the adoption of the full body of EU laws (the *acquis communautaire*) that should reduce risk premiums for investors, while accession to the customs union has lowered transaction costs.
- access to EU Structural Funds (that are intended for basic infrastructure development, human resource development, competitiveness and enterprise development, rural development and environmental protection) can contribute to an improvement of the business environment.
- the full membership in the European Monetary Union envisaged by the end of this decade is expected to lead to falling interest rates in the coming years, which would improve financing conditions in these countries.

However, despite entry into the EU and the expected burst of investor interest, risks persist in the new EU member countries. A recent survey has shown that corporate investors perceive poor infrastructure, corruption and the gradual erosion of low-cost advantage as leading threats to the competitiveness of the ten new EU members. EU reforms are expected to bring infrastructure investments and give regulatory stability to the EU single market, but the economic and social costs of adjustment are also expected to be high. Rising incomes may erode wage competitiveness. EU law will likely add a new layer of regulations and may undermine new members' relative FDI advantages in areas such as taxes and labour costs. These factors could also push investors further east and south outside the new EU.

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Appendix

Table A 1 Foreign direct investment inward stock in 1990 – 2004

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
ECONOMY	FDI INWARD STOCK (BLN OF 2004 DOLLARS)														
World	2 556	2 681	2 680	2 835	3 087	3 424	3 702	4 133	4 792	5 572	6 344	6 607	7 042	8 200	8 902
Developed economies	2 030	2 113	2 056	2 117	2 292	2 547	2 687	2 768	3 312	3 734	4 360	4 547	5 053	5 972	6 470
EU-15	1 086	1 145	1 119	1 122	1 253	1 388	1 444	1 449	1 844	1 989	2 278	2 411	2 791	3 508	3 794
EU-10	3.5	7.5	12.3	17.9	23.7	38.8	48.5	59.9	81.0	93.1	107.2	125.6	161.9	195.1	230.0
ECONOMY	FDI INWARD STOCK (SHARES IN %)														
Developed economies (world = 100%)	79,4	78,8	76,7	74,7	74,2	74,4	72,6	67,0	69,1	67,0	68,7	68,8	71,8	72,8	72,7
EU-15 (world = 100%)	42,5	42,7	41,7	39,6	40,6	40,5	39,0	35,1	38,5	35,7	35,9	36,5	39,6	42,8	42,6
EU-10 (world = 100%)	0,1	0,3	0,5	0,6	0,8	1,1	1,3	1,4	1,7	1,7	1,7	1,9	2,3	2,4	2,6
EU-15 (Developed economies = 100%)	53,5	54,2	54,4	53,0	54,7	54,5	53,7	52,4	55,7	53,3	52,2	53,0	55,2	58,8	58,7
EU-10 (EU-15 = 100%)	0,3	0,7	1,1	1,6	1,9	2,8	3,4	4,1	4,4	4,7	4,7	5,2	5,8	5,6	6,1

Source: compiled on the basis of UNCTAD data – Handbook of Statistics On-Line (<http://www.unctad.org>)

Table A 2 Foreign direct investment inflows in 1990 – 2004

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
ECONOMY	FDI INFLOWS (BLN OF 2004 DOLLARS)														
World	300,4	223,6	227,8	297,6	330,5	422,7	472,8	574,0	812,4	1 238,2	1 531,3	880,5	752,2	649,5	648,1
Developed economies	248,7	162,3	151,5	188,2	193,4	271,1	282,6	334,1	583,8	962,6	1 243,7	635,7	575,4	454,0	380,0
EU-15	139,7	107,9	97,6	94,5	98,7	144,4	136,3	152,9	306,9	545,7	739,6	387,0	417,2	335,3	196,1
EU-10	1,6	5,6	6,9	10,4	7,8	15,7	13,4	15,0	19,5	23,0	23,9	20,9	24,5	12,4	20,3
ECONOMY	FDI INFLOWS DYNAMICS (PREVIOUS YEAR = 100)														
World	–	74,4	101,9	130,7	111,1	127,9	111,9	121,4	141,5	152,4	123,7	57,5	85,4	86,3	99,8
Developed economies	–	65,3	93,4	124,2	102,7	140,1	104,3	118,2	174,7	164,9	129,2	51,1	90,5	78,9	83,7
EU-15	–	77,2	90,5	96,8	104,4	146,4	94,4	112,1	200,7	177,8	135,5	52,3	107,8	80,4	58,5
EU-10	–	349,4	124,0	150,8	75,0	202,0	85,5	111,2	130,4	117,8	104,1	87,2	117,3	50,6	164,2
ECONOMY	FDI INFLOWS (SHARES IN %, WORLD = 100)														
Developed economies	82,8	72,6	66,5	63,2	58,5	64,1	59,8	58,2	71,9	77,7	81,2	72,2	76,5	69,9	58,6
EU-15	46,5	48,3	42,9	31,7	29,8	34,2	28,8	26,6	37,8	44,1	48,3	44,0	55,5	51,6	30,3
EU-10	0,5	2,5	3,0	3,5	2,4	3,7	2,8	2,6	2,4	1,9	1,6	2,4	3,3	1,9	3,1

Source: compiled on the basis of UNCTAD data – Handbook of Statistics On-Line (<http://www.unctad.org>)

Table A 3 Foreign direct investment inward stock in new EU member countries

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
ECONOMY	FDI INWARD STOCK (BILLIONS OF 2004 DOLLARS)														
EU-10	3.5	7.5	12.3	17.9	23.7	38.8	48.5	59.9	81.0	93.1	107.2	125.6	161.9	195.1	230.0
Cyprus	—	—	—	—	—	—	0.4	1.1	1.4	2.3	3.1	4.1	5.2	7.1	8.1
Czech Rep.	—	—	—	4.5	5.8	9.1	10.3	10.9	16.7	19.9	23.7	28.9	40.6	46.5	56.4
Estonia	—	—	0.1	0.3	0.6	0.8	1.0	1.3	2.1	2.8	2.9	3.4	4.4	6.7	9.5
Hungary	0.8	2.9	4.6	7.3	9.0	14.0	16.0	21.1	24.0	26.4	25.1	29.2	38.1	49.6	60.3
Latvia	—	—	0.2	0.3	0.6	0.8	1.1	1.5	1.8	2.0	2.3	2.5	2.9	3.4	4.5
Lithuania	—	—	0.1	0.2	0.4	0.4	0.8	1.2	1.9	2.3	2.6	2.8	4.2	5.1	6.4
Malta	0.7	0.8	0.8	0.9	0.5	0.7	1.0	1.0	1.4	2.1	2.6	2.7	2.6	3.2	3.6
Poland	0.1	0.6	1.8	3.4	4.8	9.7	13.8	17.1	26.0	29.6	37.5	44.0	50.8	56.7	61.4
Slovakia	—	—	—	0.5	0.8	1.0	1.5	2.0	2.5	2.6	4.1	5.2	9.0	12.2	14.5
Slovenia	—	—	1.1	1.3	1.7	2.3	2.5	2.6	3.2	3.1	3.2	2.8	4.3	4.6	5.0
ECONOMY	FDI INWARD STOCK (SHARES IN %. EU-10 = 100%)														
Cyprus	—	—	—	—	—	—	0.9	1.8	1.8	2.5	3.0	3.3	3.2	3.7	3.5
Czech Rep.	—	—	—	25.0	24.5	23.5	21.3	18.2	20.6	21.4	22.1	23.0	25.1	23.8	24.6
Estonia	—	—	1.1	1.9	2.5	2.2	2.0	2.3	2.6	3.0	2.7	2.7	2.7	3.4	4.1
Hungary	23.2	39.0	37.5	40.7	38.2	36.1	33.0	35.3	29.7	28.3	23.4	23.3	23.5	25.4	26.3
Latvia	—	—	1.9	1.6	2.3	2.0	2.3	2.5	2.2	2.2	2.1	2.0	1.8	1.7	2.0
Lithuania	—	—	1.2	1.0	1.7	1.1	1.7	2.0	2.3	2.5	2.4	2.3	2.6	2.6	2.8
Malta	19.0	10.0	6.4	4.7	2.2	1.8	2.1	1.7	1.7	2.3	2.4	2.2	1.6	1.7	1.5
Poland	4.4	7.9	15.0	19.1	20.4	25.0	28.5	28.7	32.1	31.8	35.0	35.0	31.3	29.1	26.7
Slovakia	—	—	—	2.9	3.2	2.6	3.1	3.3	3.0	2.8	3.8	4.1	5.5	6.2	6.3
Slovenia	—	—	9.2	7.0	7.4	6.0	5.1	4.3	4.0	3.3	3.0	2.2	2.7	2.3	2.2
ECONOMY	FDI INWARD STOCK PER CAPITA [USD]														
EU – 15	2 062	2 256	2 262	2 325	2 652	3 009	3 213	3 288	4 236	4 658	5 497	5 964	6 981	8 941	9 891
EU – 10	37	72	122	182	247	416	535	677	931	1 095	1 304	1 573	2 062	2 545	3 079
Cyprus	***	***	***	***	***	***	472	1 191	1 625	2 650	3 701	4 838	6 089	8 557	9 847
Czech Rep.	—	—	—	331	440	711	830	895	1 396	1 707	2 108	2 642	3 774	4 424	5 515
Estonia	—	—	62	171	320	466	579	817	1 310	1 790	1 935	2 329	3 135	4 854	7 138
Hungary	55	204	331	539	686	1 094	1 288	1 745	2 018	2 269	2 237	2 687	3 560	4 761	5 959
Latvia	—	—	66	85	171	246	380	523	646	751	878	988	1 174	1 408	1 938
Lithuania	—	—	29	37	88	97	194	291	458	586	667	766	1 148	1 436	1 855
Malta	1 292	1 492	1 585	1 757	1 111	1 488	2 216	2 235	3 036	4 809	6 088	6 499	6 162	7 880	8 897
Poland	3	11	36	68	98	203	297	377	581	674	886	1 068	1 251	1 432	1 593
Slovakia	—	—	—	75	111	151	232	310	395	421	691	895	1 579	2 196	2 685
Slovenia	—	—	433	489	697	960	1 038	1 114	1 405	1 366	1 471	1 323	2 089	2 260	2 522

Missing Values: — Not applicable *** Negative accumulation of flows; value included in regional and global totals

Source: compiled on the basis of Table A5.

Table A 4 Foreign direct investment inflows to new EU member countries

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
ECONOMY	FDI INFLOWS (BILLIONS OF 2004 DOLLARS)														
EU –10	1.5	5.6	6.9	10.4	7.8	15.7	13.5	15.0	19.5	23.0	23.9	20.9	24.5	12.4	20.3
Cyprus	0.2	0.1	0.1	0.1	0.1	0.5	0.5	0.6	0.4	0.9	0.9	1.0	1.1	1.0	1.2
Czech Rep.	–	–	–	0.9	1.1	3.2	1.7	1.5	4.3	7.2	5.5	6.0	8.9	2.2	4.5
Estonia	–	–	0.1	0.2	0.3	0.3	0.2	0.3	0.7	0.4	0.4	0.6	0.3	0.9	0.9
Hungary	0.9	4.1	4.7	6.4	2.9	6.3	4.0	4.9	3.9	3.8	3.0	4.2	3.2	2.2	4.2
Latvia	–	–	0.04	0.1	0.3	0.2	0.5	0.6	0.4	0.4	0.5	0.1	0.3	0.3	0.7
Lithuania	–	–	0.01	0.04	0.04	0.1	0.2	0.4	1.1	0.6	0.4	0.5	0.8	0.2	0.8
Malta	0.1	0.1	0.1	0.1	0.2	0.2	0.4	0.1	0.3	1.0	0.7	0.3	–0.5	0.3	0.4
Poland	0.1	0.4	0.9	2.2	2.4	4.5	5.4	5.8	7.4	8.2	10.3	6.1	4.3	4.2	6.2
Slovakia	–	–	–	0.2	0.4	0.3	0.5	0.3	0.8	0.5	2.1	1.7	4.3	0.7	1.1
Slovenia	–	–	0.2	0.2	0.2	0.2	0.2	0.4	0.3	0.1	0.2	0.4	1.8	0.4	0.5
ECONOMY	FDI INFLOWS (SHARES IN %. EU–10 = 100%)														
Cyprus	12.1	2.0	2.1	1.0	1.2	3.0	3.8	4.3	2.1	4.0	3.9	4.8	4.5	8.4	5.6
Czech Rep.	–	–	–	8.2	14.2	20.2	12.8	10.2	22.1	31.2	22.9	28.8	36.4	17.4	21.9
Estonia	–	–	1.6	2.0	3.5	1.6	1.4	2.1	3.5	1.5	1.8	2.8	1.2	7.4	4.6
Hungary	59.3	73.7	57.8	61.6	37.4	40.2	29.5	32.8	19.8	16.3	12.7	20.1	12.9	17.9	20.5
Latvia	–	–	0.6	0.6	3.5	1.4	3.4	4.1	2.1	1.7	1.9	0.7	1.1	2.5	3.2
Lithuania	–	–	0.2	0.4	0.5	0.6	1.4	2.8	5.5	2.4	1.7	2.3	3.1	1.5	3.8
Malta	4.4	1.9	0.8	0.9	2.6	1.0	2.6	0.6	1.7	4.3	2.9	1.3	–1.8	2.4	2.1
Poland	8.5	7.3	13.3	21.6	30.7	28.8	40.2	38.6	37.8	35.9	42.8	29.2	17.7	34.2	30.3
Slovakia	–	–	–	2.3	4.5	2.0	3.3	1.8	4.2	2.1	8.8	8.1	17.6	5.5	5.5
Slovenia	–	–	2.2	1.4	1.9	1.2	1.6	2.6	1.3	0.5	0.6	1.9	7.2	2.8	2.5
ECONOMY	FDI INFLOWS (DYNAMICS. PREVIOUS YEAR = 100)														
EU –10	–	349.4	124.0	150.8	75.0	202.0	85.5	111.2	130.4	117.8	104.1	87.2	117.3	50.6	164.2
Cyprus	–	62.0	126.6	75.3	88.1	487.7	110.8	124.7	62.1	230.6	101.7	107.3	110.3	93.5	110.4
Czech Rep.	–	–	–	–	129.5	286.8	54.1	89.0	281.7	166.4	76.2	110.0	148.2	24.2	206.9
Estonia	–	–	–	191.9	129.3	91.4	72.6	172.9	214.3	51.4	122.7	136.2	51.6	306.6	101.2
Hungary	–	454.5	97.2	160.8	45.5	217.2	62.8	123.5	78.8	97.2	80.7	138.5	74.9	70.6	187.7
Latvia	–	–	–	150.7	463.4	81.8	206.1	133.3	67.5	95.1	115.1	31.1	189.6	115.4	210.1
Lithuania	–	–	–	291.4	100.7	229.1	202.2	228.3	256.9	51.4	75.4	114.4	161.7	23.9	420.6
Malta	–	160.7	50.4	167.5	220.3	81.1	218.9	27.4	336.3	303.3	69.3	40.5	–162.1	–67.5	139.5
Poland	–	313.8	226.1	245.7	106.5	189.8	119.4	106.7	127.7	111.8	124.3	59.5	71.2	97.6	145.5
Slovakia	–	–	–	–	148.6	91.9	139.3	61.0	301.5	59.2	435.0	80.0	254.7	16.0	163.4

Missing Values: – Not applicable

Source: Compiled on the basis of Table A6.

Table A 5 FDI inward stock

FDI INWARD STOCK (BILLIONS OF USD)															
ECONOMY	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
World	1 768.6	1 932.8	1 991.4	2 168.5	2 423.4	2 763.1	3 075.9	3 512.8	4 135.7	4 914.8	5 786.0	6 197.7	6 703.6	7 987.1	8 902.2
Developed economies	1 404.4	1 523.7	1 527.4	1 619.8	1 799.2	2 055.8	2 233.2	2 352.5	2 858.3	3 293.8	3 976.4	4 265.5	4 810.6	5 816.3	6 469.8
EU 15	751.3	825.4	831.3	858.6	983.3	1 120.1	1 200.1	1 231.8	1 591.1	1 754.5	2 077.1	2 261.5	2 657.4	3 416.9	3 794.2
(MILLIONS OF USD)															
EU-10	2 451	5 396	9 141	13 713	18 571	31 318	40 263	50 868	69 883	82 101	97 726	117 754	154 163	190 059	229 734
Cyprus	***	***	***	***	***	***	351	897	1 242	2 056	2 910	3 855	4 912	6 986	8 132
Czech Rep.	—	—	—	3 423	4 547	7 350	8 572	9 234	14 375	17 552	21 644	27 092	38 669	45 287	56 415
Estonia	—	—	96	258	473	674	825	1 148	1 822	2 467	2 645	3 160	4 226	6 511	9 530
Hungary	569	2 107	3 424	5 576	7 087	11 304	13 282	17 968	20 733	23 260	22 870	27 407	36 224	48 320	60 328
Latvia	—	—	176	221	436	615	936	1 272	1 558	1 795	2 084	2 328	2 751	3 282	4 493
Lithuania	—	—	107	137	321	352	700	1 041	1 625	2 063	2 334	2 665	3 981	4 960	6 389
Malta	465	542	582	651	416	562	844	858	1 174	1 873	2 385	2 561	2 441	3 136	3 557
Poland	109	425	1 370	2 621	3 789	7 843	11 463	14 587	22 461	26 075	34 227	41 247	48 320	55 268	61 427
Slovakia	—	—	—	400	592	810	1 247	1 671	2 129	2 272	3 733	4 836	8 530	11 864	14 501
Slovenia	—	—	841	954	1 365	1 886	2 043	2 193	2 765	2 687	2 894	2 602	4 109	4 446	4 962

Source: Compiled on the basis of UNCTAD data – *Handbook of Statistics On-Line* (<http://www.unctad.org>)

Table A 6 FDI inflows

FDI INFLOWS (BILLIONS OF USD)															
ECONOMY	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
World	207.9	161.2	169.2	227.7	259.5	341.1	392.9	487.9	701.1	1092.1	1396.5	825.9	716.1	632.6	648.1
Developed economies	172.1	117.0	112.6	144.0	151.8	218.7	234.9	284.0	503.9	849.1	1134.3	596.3	547.8	442.2	380.0
EU-15	96.7	77.8	72.5	72.3	77.4	116.5	113.3	130.0	264.8	481.3	674.5	363.1	397.1	326.6	196.1
(MILLIONS OF USD)															
EU-10	1 050	4 004	5 115	7 942	6 111	12 693	11 176	12 712	16 828	20 260	21 810	19 569	23 288	12 067	20 341
Cyprus	127	82	107	83	75	376	429	547	345	813	855	944	1 057	1 011	1 146
Czech Rep.	—	—	—	654	869	2 562	1 428	1 300	3 718	6 324	4 986	5 641	8 483	2 101	4 463
Estonia	—	—	82	162	215	202	151	267	581	305	387	542	284	891	926
Hungary	623	2 950	2 955	4 892	2 286	5 104	3 300	4 167	3 335	3 312	2 764	3 936	2 994	2 162	4 167
Latvia	—	—	29	45	214	180	382	521	357	347	413	132	254	300	647
Lithuania	—	—	10	30	31	73	152	355	926	486	379	446	732	179	773
Malta	46	77	40	69	156	130	293	82	280	868	622	259	—426	294	421
Poland	89	291	678	1 715	1 875	3 659	4 498	4 908	6 365	7 270	9 343	5 714	4 131	4 123	6 159
Slovakia	—	—	—	179	273	258	370	231	707	428	1 925	1 584	4 094	669	1 122
Slovenia	—	—	111	113	117	151	174	334	216	107	136	370	1 686	337	516

Source: Compiled on the basis of UNCTAD data – *Handbook of Statistics On-Line* (<http://www.unctad.org>)

Foreign direct Investments and regional development in Ukraine

Janek Uiboupin⁵⁹
Turku School of Economics
Pan-European Institute

Abstract

Ukraine has turned to the transition to modern market economy and to accession to the European Union (EU). Ukraine is starting to get over the deep depression that began after the collapse of the Soviet Union. The interest of foreign investors in investing to Ukraine is increasing daily. Ukraine's strong position in some export markets (i.e. steel) has made Ukraine's economy increasingly attractive for foreign investors.

The aim of the paper is to bring out main characteristics regional developments in Ukraine in the focus of foreign direct investments (FDI) and foreign trade. The author tries to give a general overview of core industries and the role of foreign firms. The article also analyses the regional differences of economic development and its potential reasons. The export potential of different regions is brought out.

The results are that the foreign direct investment flow into Ukraine is one of the lowest among the CEE countries. The main target industries for FDI have been the metallurgy and since 2006 also the financial sector. One of the biggest problem for the foreign investors in Ukraine is the outdated legislation and corporate governance. Ukraine lacks nationalization law and this makes foreign investors much more careful. Ukraine's law on joint-stock companies was developed in 1991, and has not been changed. The speed of the regional development depends to large extent on FDI and trade. The fastest growing regions are Volyn, the City of Sevastopol, Kirovohrad, Zakarpattya and Crimea. The economic growth of regions of Volyn and Zakarpattya has been accelerated clearly since the EU enlargement due to close geographical position next to the EU border.

⁵⁹ Researcher (Ph.D), email: Janek.Uiboupin@tse.fi

Introduction

Ukraine is one of the largest transitions economies among the European Union (EU) eastern neighbors. Ukraine has direct borders with the EU countries after its enlargement in 2004. The Orange Revolution initiated by Viktor Yushchenko turned Ukraine's economy to the road of transition to modern market economy and to accession to EU. Ukraine is starting to get over the deep depression that began after the collapse of the Soviet Union. The interest of foreign investors in investing to Ukraine is increasing daily. Ukraine's strong position in some export markets (i.e. steel) has made Ukraine's economy increasingly attractive for foreign investors. Nevertheless, until 2004 the foreign direct investments to Ukraine remained one of the lowest among the Eastern European transition economies. Very poor legal framework and high corruption have been the main reasons for low foreign investments into Ukraine. The risks are high, but so are the returns.

The aim of the paper is to bring out main characteristics regional developments in Ukraine in the focus of foreign direct investments (FDI) and foreign trade. The remainder of the paper is structured as follows. In the second chapter a literature overview about the FDI and regional development is given; in chapter three the main tendencies, problems and characteristics of FDI into Ukraine are provided. The chapter gives overview of most attractive sectors for foreign investors and analyzes the reasons for low FDI level in Ukraine. Next, in the fourth chapter the regional development of Ukraine is discussed. The differences between leading and lagging regions are emphasized and the growth potential of different regions of Ukraine is analyzed. The conclusions and policy recommendations are given in chapter five.

Overview of previous studies on FDI and regional development

Theorists who discuss the impact of FDI on host economies underscore the importance of inter-industry and intra-industry spillover effects. The extent of intra-industry spillover effects of FDI on technology transfer depend on a particular local firm's own ability to innovate and imitate (Glass and Saggi, 1998; Petit and Sanna-Randaccio 2000). Technology diffusion with FDI is rather a complicated topic. Teece (1977) pointed out several channels for technology run to domestic firms, namely labor flow from foreign to domestic firms, imitation and liberalization (removal of entry barriers to foreign firms).

It is also suggested that spill-over effects of foreign entry depend on how much the domestic and foreign market differ by their levels of development. This phenomenon is known as the "technology gap hypothesis" which suggests that the spillover effects from FDI to domestic firms will occur only if the technology gap is not overly large and if the country has a minimum required level of human capital (Borensztein *et al* 1998; Kokko 1994; Konings, 1999). An overly large technology gap between the foreign enterprise and domestic firm will lead to the dominance of competition effects. Aitken and Harrison (1999) showed that the productivity of domestic firms was negatively affected by FDI in Venezuela, where the competition effect slightly dominated. The reason was that foreign firms were "market stealers" who forced the domestic firms to produce less, which lead to an increase in the average cost.

Besides the quantity of knowledge transfer, it is important to consider the level of quality of the knowledge transfer. Glass and Saggi (1998) found in their general equilibrium model that host countries with a higher technology gap receive lower technological quality with FDI. The capability to imitate and accept technology transfer is known as "absorptive capacity". Countries that are able to imitate more and have a more intensive level of local research and development (R&D) receive more high-quality technological FDI. Therefore their conclusion about policy is that host countries should enhance the imitation by supporting local R&D to receive high-quality FDI. Glass and Saggi (2002) found on the example of the oligopoly model that if a host firm (country) has a lower technological level than the source firm

(country), then there are at least two rationales for attracting FDI: higher profits of the host firm or a wage premium benefiting workers.

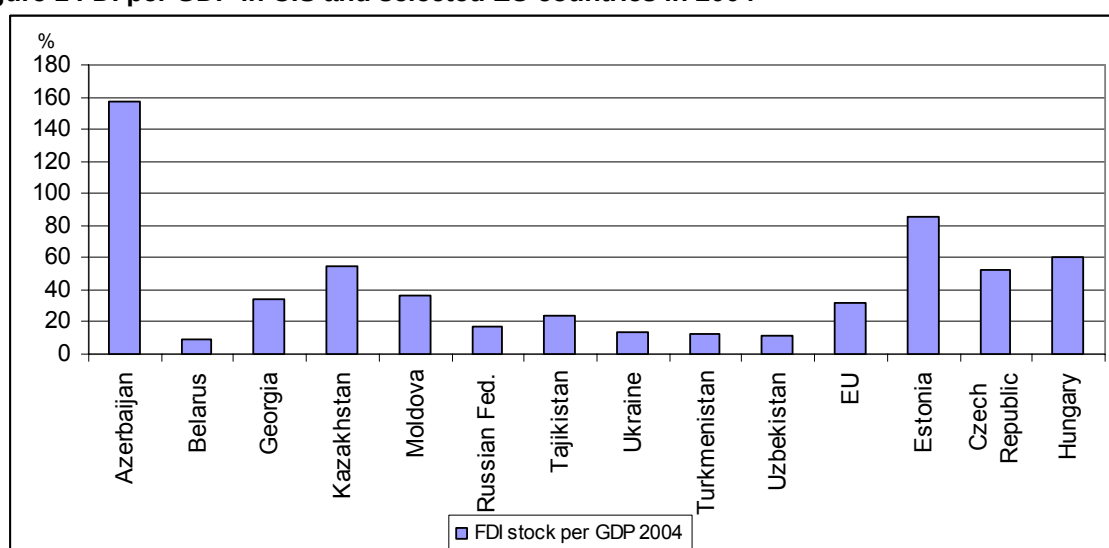
There are also several explanations for regional development and the role of FDI in regional development. Knödler and Albertshausen (2001:10) emphasize four main theoretical reasons for differences in regional development: emergence of agglomerations that generate different cost effects; gravitation effects including the role of geographic location of the region; regional polarization where the growth of agglomerations is achieved by the cost of peripheral areas; the view of new economic geography, where the firms face increasing returns to scale and imperfect competition.

Besides many positive effects of FDI on regional development, Pavlínek (2004) has brought out some negative effects and threats of FDI on regional development in Czech Republic, Poland, Hungary and Slovakia. The FDI makes regional development dependent on the decisions of the multinational companies (MNC) and therefore makes it vulnerable to investment withdrawals. Additionally, the spillover effects in transitions countries seem to be overestimated, as the relations of MNCs with local firms are relatively weak.

FDI into Ukraine

Foreign direct investment flow into Ukraine is claimed to be one of the lowest among the CEE countries. Despite the attractiveness of the market in terms of growth potential and scale, the FDI has remained modest (see Figure 1).

Figure 1 FDI per GDP in CIS and selected EU countries in 2004



Source: World Investment Report 2005; author's figure.

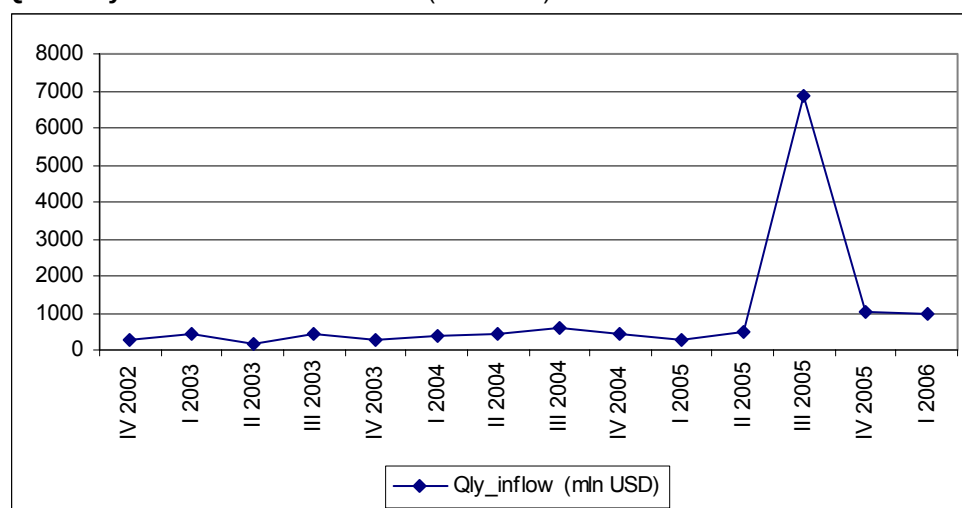
FDI inflow to Ukraine has been quite stable during period 2003 to the first quarter 2006. The quarterly average FDI inflow has been around \$500 mln (see Figure 2). The Ukrainian government has made several steps to enhance the FDI inflow. There has been several improvements in the legal framework of foreign investments. Nevertheless, one of the biggest problems for the foreign investors in Ukraine are the outdated legislation and poor corporate governance. Ukraine lacks nationalization law and this makes foreign investors much more careful. Ukraine's law on joint-stock companies was developed in 1991, and has not been changed (Ukraine: Broadening horizons, 2005). It has been noted, that Ukraine's stock exchanges lag 10 years behind compared with Russia. The EBRD assessment on Ukraine's legal framework's development was negative in 2004, with „very low compliance” with international standards.

Evidently, the most critical problem of Ukraine's FDI is a very high corruption. Ukraine was on in the 122 place among 146 countries in 2004 in the corruption index calculated by Transparency International (IMF, 2005).

The first two very significant foreign investments were made in the fourth quarter of 2005. According to State Statistics Committee (SSC) of Ukraine the FDI inflow was as much as \$6.85 bn in Q4 2005. The main investments were made to metallurgy and financial sector. Mittal Steel⁶⁰, one of the largest steel companies in the world, acquired a controlling stake in the mill Kryvorizhstal through a repeat privatization tender. The acquiring company is a subsidiary of Mittal Steel registered in Germany. The size of the investment was \$4.8 bn and due to that investment Germany became the leading investor in the country.

Another significant investment was made by Raiffeisen Banking Group from Austria. The sale of Aval bank added \$1.1 bn to Ukraine's FDI stock. The financial sector has been very attractive for foreign investors after the removal of all entry barriers to foreign banks. In July 7 the Ukrainian government confirmed a new law on "Banks and Banking Activities", according to what both domestic and foreign banks are treated equally in the Ukrainian banking sector.

Figure 2 Quarterly FDI inflow into Ukraine (mln USD)

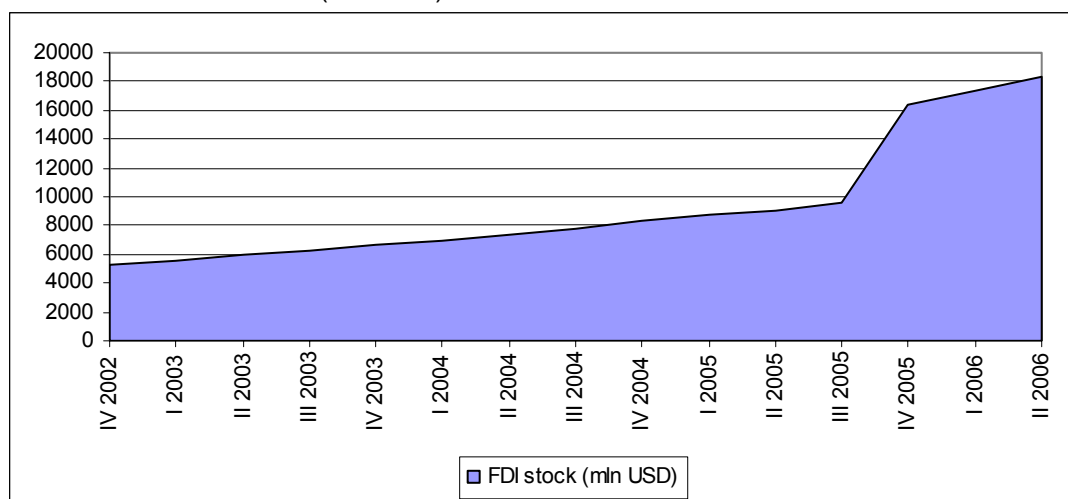


Source: State Statistics Committee of Ukraine; author's calculations

The total FDI stock has increased from 5.5bn in January 2003 to \$18,7 bn in July 2006 (see Figure 3). The FDI stock almost doubled during 2005 compared with that of 2004. The FDI stock has increased also in the first two quarters of 2006, but the growth is not that steep as it was in the fourth quarter of 2005.

⁶⁰ The headquarter of Mittal Steel is in London, Great Britain.

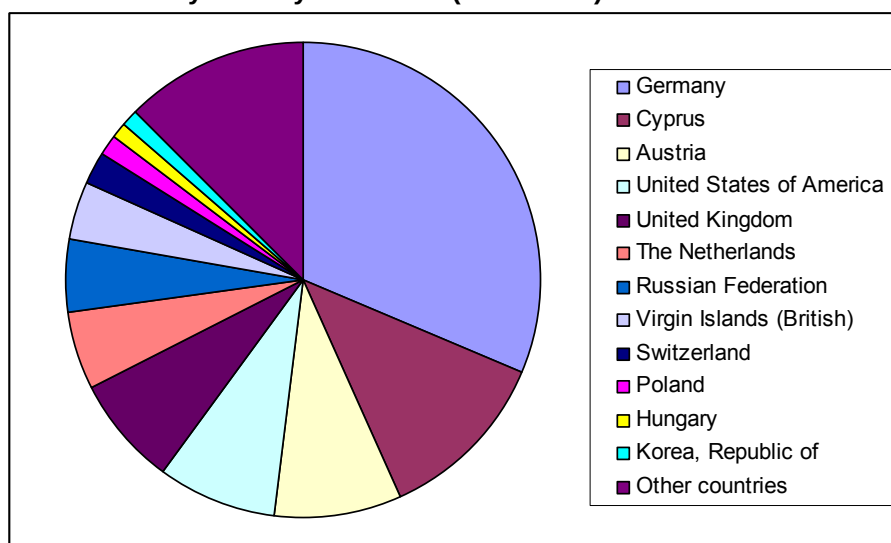
Figure 3 FDI stock in Ukraine (mln USD)



Source: State Statistics Committee of Ukraine; compiled by the author.

The FDI distribution by country in Ukraine is illustrated in Figure 4. About one third of total FDI originates from Germany, followed by Cyprus and Austria. The major investments from Germany and Austria have been already described above, namely investments to metallurgy and financial sector. The majority of FDI from Cyprus to Ukraine is said to be Ukraine's own capital reinvested.

Figure 4 FDI distribution by country in Ukraine (31.03.2006)

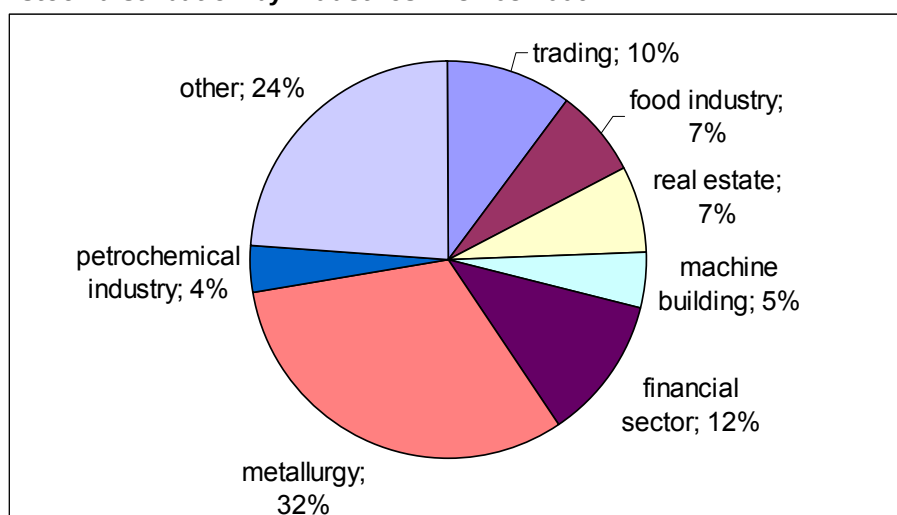


Source: State Statistics Committee of Ukraine; author's calculations

According to the Institute for Reforms (2005), the regional distribution of FDI has been very different, there are some clear leader regions and peripheral areas. The leading region is Kyiv City that has attracted about one third of all FDI into Ukraine. The other leading regions of FDI are industrial regions including Dnepropetrovsk, Donetsk and Zaporizhia.

The FDI distribution by industries as of 31.03.2006 is given on Figure 5. The highest share of investments has been made to metallurgy. The investments to metallurgy were quite moderate before the huge investment by Mittal Steel in 2005. The other more attractive sectors for FDI have been financial sector, trading, food industry, real estate, machine building, and petrochemical industry.

Figure 5 FDI stock distribution by industries in 31.03.2006



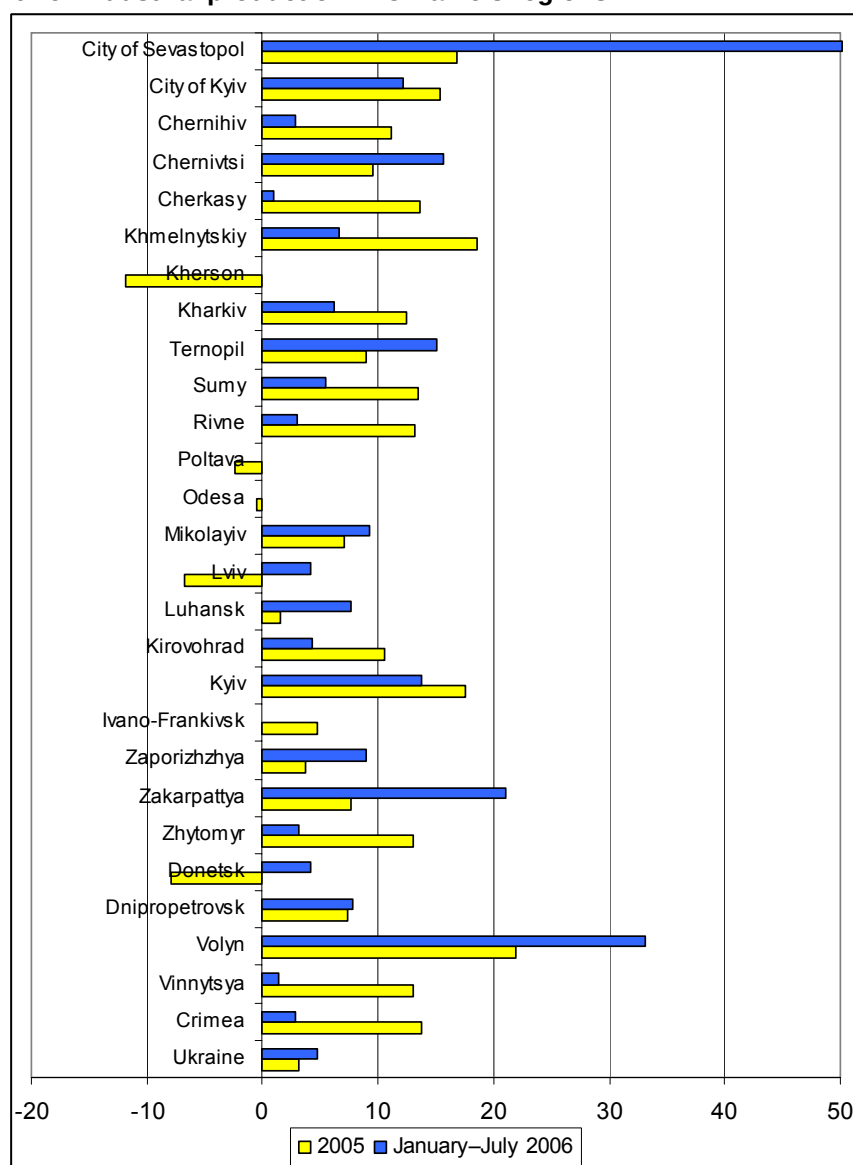
Source: National Bank of Ukraine, 2006.

The indicators of regional economic development in Ukraine

Figure 6 gives information about the growth rates of industrial production in Ukraine's regions. Volyn shows high growth numbers and the author suggests, that the proximity of EU border contributes to the fast development of Volyn region. Other fast growing regions include City of Sevastopol, City of Kyiv, Ternopil, Zakarpattya and Chernivtsi. Zakarpattya gains from the cross-border cooperation with the Czech Republic and Hungary. There are special economic zones (SEZ) formed in both Zakarpattya and Crimea. The special economic zone attracts foreign investments and enhances cross-border cooperation that contributes to economic development. Kirovohrad is another fast-growing region in Ukraine. The region is main agrarial. Volyn and City of Sevastopol had very significant growth of production in the first half of 2006 – 35-50%. There has been a decline of industrial production in Kherson during last two years. The growth in Kyiv region has been moderate, but very stable, with around 15% during last 2 and half years.

The location of rayons at the border with the neighboring states influences the level of social and economic development of these territories. The character of such an influence depends on the level of economic development of the neighboring country. After all the people living in the EU frontier territories, e.g. Zakarpattya, have more possibilities to generate additional income thanks to the local foreign economic activities, than their fellow countrymen from Chernihiv or Sumy oblasts, which neighboring with Russia and Belarus. As the results of the rating analysis show, the majority of rayons, which border on the present or prospective member countries of the European Union, have higher than the average for 494 territories of Ukraine rating point. On the other hand, for the bulk of rayons, which are located at the border with the former Soviet republics(Russia, Belarus, Moldova), the registered level of the social and economic development is lower. (Institute for reforms, 2005)

Figure 6 Growth of industrial production in Ukraine's regions*



* in %, (-) indicates decline, compared with previous year

Source: State Statistics Committee of Ukraine; author's figure.

Table 1 gives the information about the average wages in Ukraine by regions. The table 1 indicates that there are big regional differences of wages. Not surprisingly, the highest average wage is in the City of Kyiv. In August 2006 the average wage in Kyiv was 1764 UAH, while it was only 723 UAH in Ternopil, where the average wage was only 67% of total Ukraine's average. Ternopil has been one of the poorest regions in Ukraine despite the fact that it situates in the Western Ukraine. Nevertheless, Ternopil does not have direct border with EU member states and the cross-border effects to economic development are slower that in border regions. Nevertheless the wage differences between poorest regions and Ukraine's average have decreased since January 2005, that is a positive sign of development.

The other regions with higher wages include Donetsk, Dnepropetrovsk, Zaporizhzhya, and Luhansk with above than average wage level. Again, it can be included that the wages are higher in regions of industrial production. Other regions of low salaries are Vinnitsya, Volyn and Zhytomyr and Chernihiv, where the average wages make around 70-75% of Ukraine's average level. These poorest regions are all border regions. Vinnitsya is on the border of Romania, Volyn has a border with Poland and Belarus, Zhytomyr and Chernihiv have the border with Belarus. The regions of lower wages are mainly agricultural. Among the less developed regions has Volyn one of the best geographical position as it has direct border

with EU through Poland. Chernihiv may gain from the trade relations with Belarus and Russia and also from its close geographical position with Kyiv.

Table 1 Average wages by regions of Ukraine

	January 2005 (UAH)	% of Ukraine's average	August 2006 (UAH)	% of Ukraine's average
Ukraine average	640,9	100,0	1073,1	100,0
Autonomous Republic of Crimea	576,0	89,9	1004,73	93,6
Oblasts				
Vinnytsya	456,4	71,2	839,27	78,2
Volyn	450,1	70,2	795,94	74,2
Dnipropetrovsk	771,1	120,3	1166,73	108,7
Donetsk	784,7	122,4	1237,69	115,3
Zhytomyr	460,8	71,9	809,43	75,4
Zakarpattia	502,2	78,4	900,51	83,9
Zaporizhzhya	721,5	112,6	1112,2	103,6
Ivano-Frankivsk	555,5	86,7	985,79	91,9
Kyiv	651,7	101,7	1113,22	103,7
Kirovohrad	488,3	76,2	861	80,2
Luhansk	642,9	100,3	1054,57	98,3
Lviv	548,4	85,6	959,57	89,4
Mykolayiv	612,5	95,6	966,22	90,0
Odesa	640,0	99,9	978,32	91,2
Poltava	606,9	94,7	1023,16	95,3
Rivne	561,1	87,5	889,74	82,9
Sumy	507,4	79,2	923,62	86,1
Ternopil	414,9	64,7	723,12	67,4
Kharkiv	596,1	93,0	1018,1	94,9
Kherson	476,4	74,3	812,08	75,7
Khmelnyskiy	454,2	70,9	814,37	75,9
Cherkasy	486,3	75,9	874,09	81,5
Chernivtsi	476,8	74,4	860,68	80,2
Chernihiv	454,7	70,9	833,81	77,7
City of Kyiv	1024,8	159,9	1763,74	164,4
City of Sevastopol	630,9	98,4	1022,55	95,3

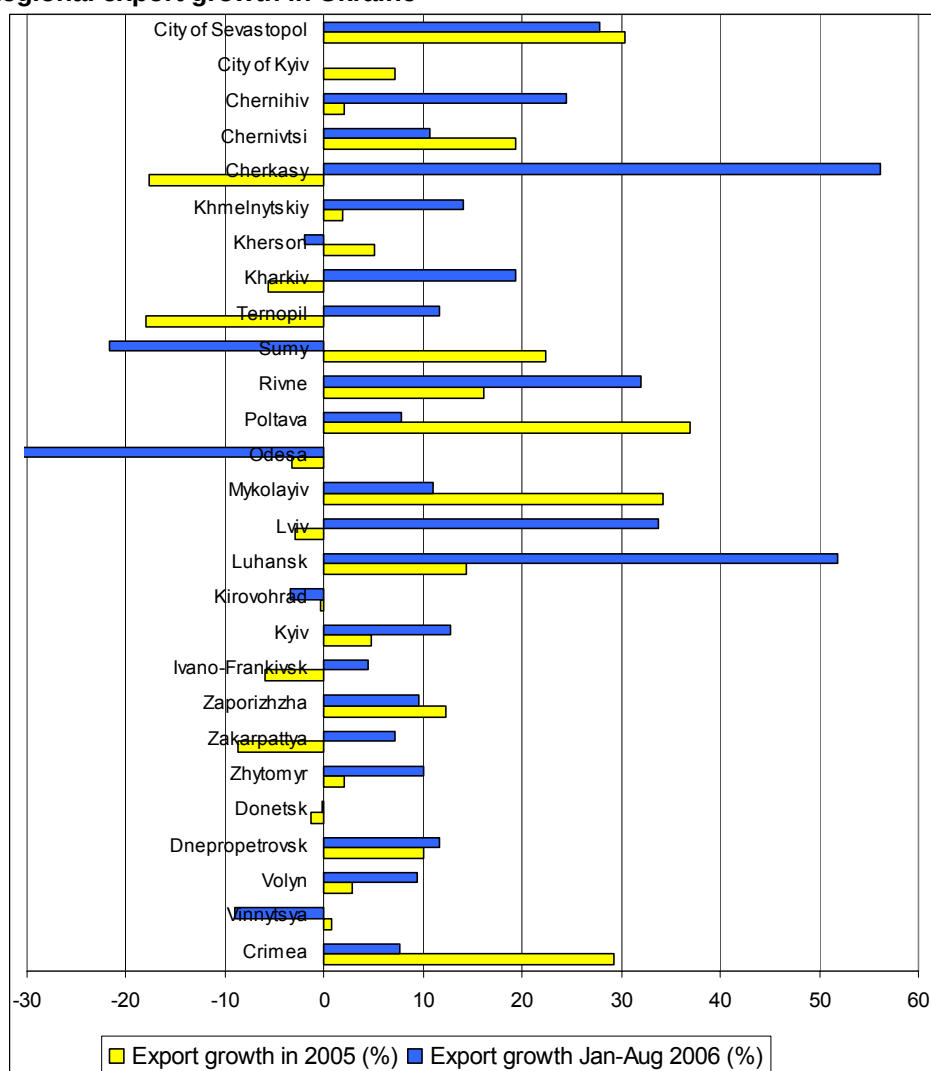
Source: State Statistics Committee of Ukraine; author's calculations.

Recent two years saw a triumph of the resort territories of the South coast of the Crimea in the Ukrainian regions rating. The somewhat forgotten status of the tourist Mecca of the former Soviet Union seems to have been restored in the last several years. One of the potential clusters in Ukraine is the tourism cluster in Crimea. The cluster does not yet exist formally, but there are some important steps made on that direction. Crimea Association of Travel Agencies (CATA) is formed to initiate better cooperation between tourism firms in that area. There still remain several problems: a big part of the tourism objects are in the hand of state, that is not a good manager; there is a lack of transparency among both public and private players; many tourists stay in Crimea unregistered in unofficial private accommodation places (Ukraine: competing in the global economy...2005). Nevertheless, an Autonomous Republic of Crimea has a good growth potential as a tourism cluster.

Statistics have recorded the constant growth of the number of tourists. According to the data provided by the Council of Ministers of the Autonomous Republic of the Crimea, in 2004 this indicator reached 6.3 mln people, which is 20 per cent more than the indicator for the previous year. (Institute for reforms, 2005)

Figure 7 gives an overview of the export growth in regions of Ukraine in 2005 and January-August 2006. The fastest growing regions in Ukraine are those that are also the main industrial regions. The figure shows that City of Sevastopol, Luhansk, Chernivtsi and Dnepropetrovsk are the regions of high and stable export growth. Although Donetsk remains one of the strongest industrial regions in Ukraine, the export growth since 2005 has been nearly zero. Most significant export growths during January-August 2006 have been in Cherkasy and Luhansk oblasts – over 50% compared with same period in 2005.

Figure 7 Regional export growth in Ukraine



Source: State Statistics Committee of Ukraine; author's calculations

It can be argued the total volume of export is also an important factor describing the export competitiveness of a region. Table 2 gives an overview about the dynamics of export share of different regions in Ukraine's total export. The importance of Dnepropetrovsk, Donetsk, Zaporizhzhia, Poltava and Luhansk in total export volume have increased in last years, indicating a strengthening economic performance.

Table 2 Regional export volume and distribution in Ukraine

Region	Export mln USD in 2005	% of total export 2005	% of total export 2004	% of total export 2003
Autonomous Republic of Crimea	355,4	1	0,8	1,4
Oblasts				
Vinnitsya	424,6	1,2	1,3	1,4
Volyn	280,8	0,8	0,8	0,9
Dnepropetrovsk	5958,3	17,4	16,6	15,6
Donetsk	8225,5	24	25,5	21,5
Zhytomyr	267,7	0,8	0,8	0,9
Zakarpattya	552,8	1,6	1,9	1,8
Zaporizhzhya	2658,7	7,8	7,3	7,5
Ivano-Frankivsk	815,2	2,4	2,7	2,9
Kyiv	496,4	1,4	1,4	1,5
Kirovohrad	199,4	0,6	0,6	0,4
Luhansk	2171,1	6,3	5,8	5,9
Lviv	621,4	1,8	2	2,1
Mykolayiv	878,3	2,6	2	2,4
Odesa	1019,4	3	3,2	4,5
Poltava	1890,1	5,5	4,2	4,4
Rivne	235,1	0,7	0,6	0,7
Sumy	577,9	1,7	1,4	1,5
Ternopil	76,1	0,2	0,3	0,3
Kharkiv	721,6	2,1	2,3	2,4
Kherson	234,6	0,7	0,7	0,6
Khmelnyskiy	184,7	0,5	0,6	0,7
Cherkasy	339,1	1	1,3	1,3
Chernivtsi	102,4	0,3	0,3	0,3
Chernihiv	250,7	0,7	0,8	0,9
City of Kyiv	4445,5	13	12,7	12,4
City of Sevastopol	80	0,2	0,2	0,2

Source: State Statistics Committee of Ukraine; author's compilation.

There is an ongoing research about the effects of special economic zones (SEZ) in transition economies. Ahrens and Meyer-Baudeck (1995) has pointed out, that SEZs are aimed to promote FDI, to enhance and diversify the production of export goods and to import modern technologies. There are several SEZs formed in Ukraine.

Conclusions

The study discussed the FDI and regional development of Ukraine. The results are that the regional development in Ukraine is quite different and it is possible to distinguish leaders and outsiders. Volyn shows highest growth numbers and the author suggests, that the proximity of EU border contributes to the fast development of Volyn region. Other fast growing regions include City of Sevastopol, Ternopil, City of Kyiv, Zakarpattya and Crimea. Zakarpattya gains from the cross-border cooperation with the Czech Republic and Hungary. There are special economic zones (SEZ) formed in both Zakarpattya and Crimea. The special economic zone attracts foreign investments and enhances cross-border cooperation that contributes to economic development. Volyn and City of Sevastopol had very significant growth of production in the first half of 2006 – 35-50%. There has been a decline of industrial

production in Kherson and Odesa during last two years. The growth in Kyiv region has been moderate, but very stable, with around 15% during last 2 and half years.

The fastest growing regions in Ukraine are those that are also the main industrial regions. The results show that Poltava, Sumy, Zaporizha and Dnepropetrovsk are the regions of high and stable export growth. After two years of rapid growth the Donetsk oblast had a negative export growth of 1.4% in 2005, but generally Donetsk remains one of the strongest industrial regions in Ukraine.

Foreign direct investment flow into Ukraine is claimed to be one of the lowest among the CEE countries. Despite the attractiveness of the market in terms of growth potential and scale, the FDI has remained modest

One of the biggest problem for the foreign investors in Ukraine is the outdated legislation and corporate governance. Ukraine lacks nationalization law and this makes foreing invertors much more careful. Ukraine's law on joint-stock companies was developed in 1991, and has not been changed (Ukraine: Broadening horizons, 2005). It has been noted that Ukraine's stock exchanges lags 10 years behind compared with Russia. Evidently, the most ciritcal problem of Ukraine's FDI is a very high corruption. Ukraine was on in the 122 place among 146 countries in 2004 in the corruption index calculated by Transparency International.

The first two very significant foreign investments were made in the fourth quarter of 2005. According to State Statistics Committee (SSC) of Ukraine the FDI inflow was as much as \$6.85 bn in Q4 2005. The main investments were made to metallurgy and financial sector. About one third of total FDI originates from Germany, followed by Cyprus and Austria. The major investments from Germany and Austria have been already described above, namely investments to metallurgy and financial sector. The majority of FDI from Cyprus to Ukraine is said to be Ukraine's own capital reinvested

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Thank you for the culture! Should policy makers consider the cultural spillovers of inward FDI? Evidence from the Baltic States

Peter Zashev⁶¹
Turku School of Economics,
Pan European Institute

Abstract

This article addresses what is perceived to be relatively less explored phenomenon as the business cultural impact of the foreign investor on the host country – in other words an attempt to underline the fact that business culture and its possible impact could be very important criteria when trying to attract and choose FDIs. The article uses as an example the Russian investments in the Baltic States. One of the conclusions the paper reaches is that in evaluating investor's attractiveness from host country point of view much more attention should be paid to "soft" values such as its business culture.

⁶¹ Senior Research Fellow, e-mail: peter.zashev@tse.fi.

Introduction

Foreign Direct Investments /FDI/ play an important role in the development of many emerging markets. The companies involved in FDI activities have a growing role for the countries and societies they operate in through bringing across borders different values, knowledge and operational business culture. Thus the impact of Multi-National Corporations /MNCs/ on host countries is important phenomenon that should be well understood and realized by managers in the MNCs and by policy makers in the host countries that are willing to create an a policy framework that maximizes the MNCs presence in their national economy landscape.

This article addresses what is perceived to be relatively less explored phenomenon as the business cultural impact of the foreign investor on the host country – in other words an attempt to underline the fact that business culture and its possible impact could be very important criteria when trying to attract and choose FDIs. The article uses as an example the Russian investments in the Baltic States and is structured in 3 different parts. The first one builds some speculative framework of how business cultural spillover could be measured. The second part deals with what exactly represents contemporary Russian business culture and which of its features could be considered as more troublesome from the point of view of a country hosting Russian FDIs. The last part tries to see if in the Baltic States we find evidence to suspect or to expect some negative spill over of Russian business culture.

Instead of conclusions the article speculates what would be the possible impact for one of the Baltic States - Estonia, if the biggest shares of FDIs did not come from Finland and Sweden as they did but from Russia.

FDI's business cultural spillover – building framework of analysis

FDIs could have significant impact on number of stakeholders in a national society and economy: on the natural environment of the host country, on its institutions, on its societal norms and values and its macroeconomic foundations.

The business cultural influence of foreign investors is a subject that is still relatively unexplored by the cross-cultural management discipline. Some studies (*Hennart & Larimo, 1998*) focus on the impact of culture on the strategy of Multi National Enterprises /MNE/ and the impact of national culture on the entry mode choice and subsidiary performance (*Slangen & Hennart, 2002*). That is they put in the focus how an enterprise, its entry strategy and operation mode are influenced by national culture and/or differences between the home culture of the company and the culture of its host country. Thus in a way at the center is the extent and pattern of international production or production financed by FDI and undertaken by MNE, which is the main subject to be explained by the eclectic paradigm (*Dunning, 2001*). A further exploration of the cultural sensitivity of the eclectic paradigm (*Dunning & Bansal, 1997*) argued that the importance of the OLI variables determining MNE activity will depend, among other factors, on the strategies and other characteristics of firms, including their corporate culture. Their corporate culture is on the other hand very much a product of their home environment including its nation specific features. Observing the same process vice versa will formulate the main question to be as what will be the effect of MNE activity on the host culture in general and business culture in particular. Such impact could be experienced in several ways. MNE operations could raise the standards of demand (*Porter, 1990*) and inject an entrepreneurial spirit and foster competitiveness locally. They can have significant impact on their suppliers and thus generate a spill over effect through raising quality standards. MNE can have significant effect on labor force through, again, raising standards and productivity

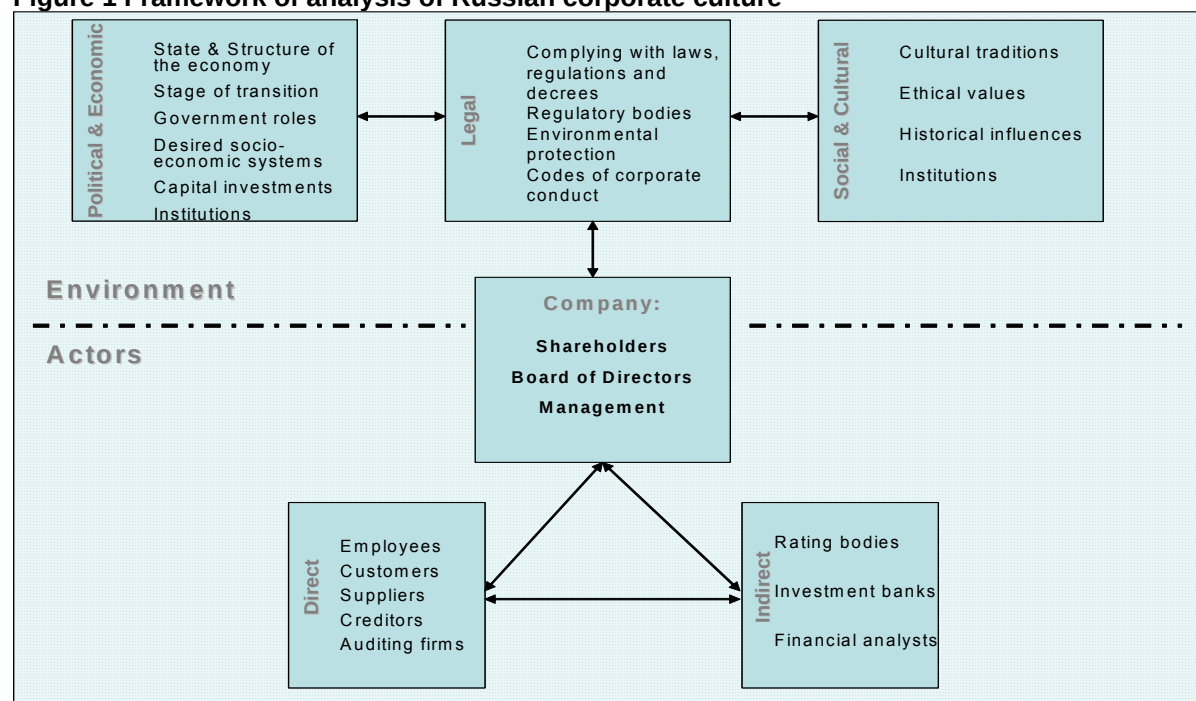
The main problem when analyzing the possible impact of business cultural spillovers of FDIs is how it could be qualified and quantified. There are many factors that should be

considered. One is the size of the investor's home country and economy and the size of the country/economy - recipient of the investment. For instance, Lukoil acquisition of the Getty Petroleum marketing (gas stations chain) in the USA is unlikely to have significant cultural impact due to the geographic and economic size of the country recipient of the investment. On the other hand, the Russian investments in Latvia are more likely to have tangible impact in terms of business cultural impact as both Latvian geography and economy are considerably smaller (Zashev, 2005).

Another factor to be considered is how far apart are the investor's home country and the investor's host country in terms of national cultures. The latter could be described in terms of language, religion, ethnicity, shared history etc. Or it could be compared in terms of the Hofstede dimensions. Last but not least the size of the investments should be also considered and measured not only in absolute terms but also in terms of their impact and importance for the economy of the host country. In the absence of an established methodological instrument for measuring the business cultural spill over of an international investor the paper will use some bits from a framework of analysis shown in Figure 1. The framework draws on a model suggested originally by McCarthy and Puffer (2003). It is important to note that the system should be viewed as a system of interrelated forces with different impact factors. Thus a change in any element affects others, while simultaneously affecting the company and its corporate culture at the centre of the framework.

According to a study by Perlmutter MNEs may differ in their inclination to transfer their home practices abroad based on their levels of ethnocentricity, polycentricity or egocentricity (Perlmutter, 1969). Thus MNEs are likely to have a more pronounced effect on the culture of the countries in which they do business because of the long term and embedded nature of their activities. To repeat, the main problem is how that effect could be qualified and quantified. Especially that there are no studies that go bold enough to argue that the business culture of the investors could be valued in the most reliable of terms – in money.

Figure 1 Framework of analysis of Russian corporate culture



Source: Zashev, 2005.

Within the proposed framework this article chooses to focus on what is perceived as the three most tangible impacts of investor's business culture. In our perception that will be on its employees in the host countries, on the institutions in the host country and on the host country's legal environment. The first one deals primarily with the **intra corporate culture** –

managerial styles and practices and how much attention and effort is spent on continuous learning and training of local personnel. In these directions the “good” investor would aim at raising the work quality and improving the efficiency – both having crucial impact on long-term competitiveness and profitability. In addition the investor may bring along managerial culture that will be more advanced (efficient, ethical, flexible, creative etc.) that what could be considered as average in the host country. In short foreign investors in general and MNC in particular are expected to be involved in a serious transfer of knowledge provided the subsidiary is prepared and fit to absorb these knowledge (Minbaeva et. al., 2003). This study indicated that investments in employees’ ability and motivation through the extensive use of HRM practices contribute to MNC knowledge transfer.

Another crucial ingredient is the relations between the investor and the host country institutions. Two points are of crucial importance. First is the **respect for the rule of law** and believing that law is above all and one’s operations should be strictly in accordance with the legislative environment. Second is the **respect for the institutions** that are supposed to create the legal environment and make sure that everyone plays according to the existing rules. Shortly, different investors (for different reasons) have different perception of what is legal and what is not, what is bribing and what is not and if corruption is a way to solve a problem speedily or a menace one should fight by all means.

Last but not least, investor’s business culture could include politically biased values of serving the national (country of origin) interests. Such a bias could also have significant impact on the local society in general.

Based on these three main perceived impacts the main question in this paper is formulated as follows:

Should the policy makers in the Baltic States seriously consider the business culture of Russian investors among other factors when attracting FDI?

The concerns with Russian business culture

Factors forming the contemporary business culture

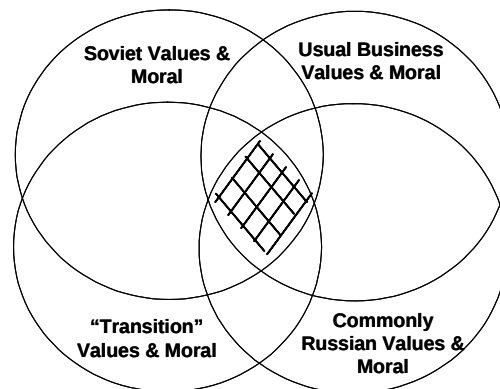
There are many studies dedicated to different aspects of Russian business culture, management. They are often focused more into some specific issue of Russian business culture. Some have more general nature (Apressyan 1997, Grachev & Izyumov 2003, Kuznetsova & Kuznetsov 2003), others focus on management perspectives (Ardichvilli et al. 1998, Liuhto 1999, Robertson et.al. 2003, De Vries et al. 2004), corporate governance (McCarthy & Puffer 2002, 2003, Perotti & Gelfer 2001) or some sadly specific for Russia issues such as corruption (Levin & Satarov 2000). These are just few of the many research papers published on the topic.

One way to describe the layers that form the contemporary Russian business culture is to unite them in four sets of factors as shown in Figure 2. The contemporary Russian corporate culture could be presented as the cross-section of these four different sets of factors and their consequent impact on collective and individual culture and mentality.

The first set is formed by the traditional Russian values and norms that distinct Russians as compared to other national cultures. The second set could be defined as those norms and values that were added / enforced to the Russian mentality during the time of the Soviet Union. The third set represents those new developments and modifications in mentality and culture that the last 12 years of transition process required from every social group and/or individual in Russia. Finally, the fourth set of factors is assembled by the influence of Western business culture whose impact constantly increases due to the increased business interaction.

A brief critical survey of the four sets is provided below focusing on the influence they have had and the features they have brought to contemporary Russian corporate culture.

Figure 2 Four sets of factors forming the contemporary Russian business culture



Source: Zashev 2004.

Commonly Russian values and moral

As one of the most striking factors influencing the commonly Russian business values and moral could be underlined the near total lack of competition in the Russian social and economical life – an argument that was pointed out by many authors (see e.g. Prohorov, 2002). Thus among the three main features of the Moscow state were:

- *militaristic nature* as the state had to fight external enemies and expand further geographically
- *society based on force rather than law* with clearly determined division of social groups. These groups differ by their duties rather than by their rights.
- *supreme power of the state / tsar* with not clarified and unlimited authority space

All these features were slowly suffocating the very concept of free competition in the allocation of any type of resources – human, financial, natural etc. As a result a highly centralized system was built where the state in the face of the Russian emperor had unlimited and not clarified powers. The latter were transmitted to the rest through an ever growing, slow and inefficient apparatus of state bureaucracy.

It is not by a surprise that in such conditions the competitiveness was directed mainly on attracting the attention of the supreme power through gifts, bribes and network of important acquaintances. That is how events such as the scandals of cronyism surrounding the close circle around Peter the Great or the ‘Potemkin village’ could be explained.

Such system will also partially explain that all prominent international Russian business projects – be there in railways, investments or simple exports were in most cases directly or indirectly sanctioned and/or financed by the state.

Soviet values and moral

The system did not change much in the soviet times – instead to a fair degree it became worse. The state succeeded into implementing total control on all activities – control which could be characterized as deeper and broader if compared to the centralized administration during tsar’s times.

Again the state had the not clarified and unlimited authority to allocate resources of all types. Furthermore the state imposed an ideological embargo that additionally stalled the system. The Soviet rule also imposed concepts such as the ‘uravnilovka’¹ that eliminated the link between work and pay, ‘planning’ versus market that geared further the bureaucracy and

made cheating an inbuilt part of the economic system, 'repression' that became a state concept and thus eliminated initiative, decision making and freedom of choice.

Again, surviving and economic (and physical) prospering in the system was dependant on one's links to the state power in its various forms: communist party, state administration, military, KGB etc. Again the competition was leveled down to none as most factories obtained a monopolist status and were given predetermined figures on input and output.

The Soviet system also did not succeed to eliminate the corruption and bribing that plagued the Russian state machine in the times of the tsar. Quite the opposite, in the presence of an almost total deficit for goods and services corruption became the normal way of life. The basic lesson Soviet managers learned was that being obedient to the system through keeping a low profile was the best strategy to follow. Maximizing the requested from the planning committee input and minimizing the expected output was a common strategy.

The foreign operations of Soviet companies were an absolute state monopoly controlled by the party, the state and KGB. Officially only the Foreign Trade Organizations were authorized to link Soviet factories with their overseas markets, suppliers, partners etc. Any investment decision, be it a power plant in Cuba, factory in Sudan or military equipment to Egypt was part of a conscious centrally planned and controlled foreign policy rather than a money wise business rational based decision.

Transition values and moral

Perhaps the most interesting and intriguing period that has a considerable influence on the Russian business culture is the economic and political transition that Russia is experiencing for the last 14 years.

A dramatic (by the Russian standards) change has appeared in the form of a massive (initial) retreat of the state. Dodgy or not, fair or not, the privatization in Russia created in few years a new social group of owners – investors, capitalists, industrialists etc. Still, it must be noticed that it was not their entrepreneurial spirit that was the main factor for their success. It was rather a well build network of contacts with the government at all different levels in combination with a total disrespect for the 'transitional' semi-Soviet, semi-market legal system.

The state retreat in the 1990s and its inability to perform vital functions generated huge vacuum in the economic and social situation in Russia. Russian managers at the time were imposed to number of stressful forces as shown in Figure 3.

Figure 3 Sources of pressure on company management



Source: Zashev 2004.

One of them was the high inflation that was making business itself a difficult task and almost impossible to make any mid- or long-term business decisions and planning. Such a high degree of unpredictability was one of the main reasons for Russian managers to be focused mainly on short term incomes, profits etc. Another reason for that was the absence of normal corporate banking (that still continues) and of bank credits to businesses. That meant that alternative sources of financing are needed. Such are provided typically very risky conditions and from very risky places.

Another serious obstacle was the growing organized crime that was constantly trying (and to a large degree succeeded) to be deeply involved in business. Drugs, prostitution and racketeering were only the initial operations that soon went into much more sophisticated schemes such as tax dodging, money laundering, banking and privatization. In the presence of next to none existing legal system and dysfunctional courts business disputes and debt collection became a domain of activities for the organized crime.

Not succeeding into building a stable macroeconomic environment, launching a failed bank reform, not effectively combating organized crime were perhaps not the biggest shortcomings of the Russian state in the early 1990s. The worst three pressures that the state offered to businesses and managers were extremely weak and corrupted institutional / bureaucratic machine, practically disabled courts and an unrealistic tax system that made most members of the business community outlaws by definition. Surprisingly during the 1990s the state stopped performing vital duties of control and regulation but still remained the prior arbiter with the known from history not clarified and unlimited rights to interfere into everybody's business and daily life.

The fear of Russian business culture

From the presented above evidence one may jump to the somewhat dark conclusion that Russian companies are some sort of puppets in the hands of the Russian state machine, that they bribe themselves out of any situation, rely mainly on informal networking, have overmanned and inefficient labor and managerial practices and generally in their survival mechanism there is little respect for the rule of law. To some extent this description may fit many Russian companies operating in Russia.

Hence, if serious problems of business ethics plague and continue to plague the way business is conducted within Russia, the internationalization of Russian companies puts forward the question what exactly business cultural influence they spread when they internationalize? Standardization or localization - do Russian companies and executives use a standardized approach of utilizing Russian business culture or they try to adapt to the local environment? Is the statement that Russians see no problem with favoritism, price fixing, ignoring senseless laws and regulations and manipulating data (Puffer, 1996) valid and do they bring such type of thinking in their foreign operations?

The discussed above assumptions provide enough reason to assume that as most worrying features of expected business cultural spill over of Russian business culture could be listed:

- transmitting dubious quality of corporate management and organization.
- underestimation of such concepts as efficiency and productivity and their direct link with personnel training and continuous learning.
- the understanding that bribing is a normal way to "speed up" or "smoothen" interaction with authorities at various levels.
- the unbroken link/dependence of Russian companies on the Russian state and resulting from it political versus economic motivation when making corporate decisions.

Russian business culture in the Baltic States

Productivity and efficiency issues

Russian companies are likely to insert their highly vertical corporate management structure where power distance is high and responsibilities are centralized in one (or maximum) several persons. That is in a contrast to the Nordic management style that puts an emphasis on coordination instead of control and prefers more flat type horizontal managerial style. What is more alarming is that Russian companies are much less likely to spent money on continuous learning and training for their personnel. Comparing the costs for personnel training in Russian banks in the Baltic States with Swedish banks one may come to the conclusion that personnel training is not among the priorities of the Russian investor.

Table 1 Productivity levels in Russia and Finland measured on a turnover per employee basis

2002	Industry branch	Russia Productivity in thousand RUB per employee	Russia Productivity in EUR (1 EUR = 34,5 RUB) per employee	Finnish companies from same industry branch	Productivity in EUR per employee	Difference Coefficient /in times/ ⁶²
1	Oil & Gas	1613.8	46 777	Fortum /Oil Division/	1 674 419	35,8
				TotalFina /France/	844 166	18,05
2	Non-ferrous metals	896.2	25 976	Outokumpu Group, Finland	315 789	12
3	Ferrous metals	795.1	23 046	Rautaruukki	180 365	7,83
4	Food processing	822.3	23 835	HK Ruokatalo	134 792	5,66
5	Machine building and metal processing	350.0	10 145	Sten & Co. Oy	304 878	30,1
6	Construction materials	426.4	12 359	Paroc	154 839	12,53
7	Chemical and petrochemical industry	554.2	16 064	Kemira	260 762	16,2
8	Electricity – production & distribution	885.2	25 658	Turku Energia	406 040	15,8
9	Forestry and Pulp & Paper	414.1	12 003	Vierumäen Teollisuus /forestry/	304 688	25,4
10	Light industry	178.4	5 171	Turun Kirjekuoritehdas	168 750	32,6

Source: (AKM, 2003 and different company info compiled by the author⁶³)

⁶² It must be considered also that the average pre-taxes monthly wage in Finland for 2003 was 2 322 EUR (Statistics Finland, 2004) while in Russia the average pre-tax monthly wage was 5,512 rubles (which amounts to 160 Euro at the current exchange rate and about 450 Euro when adjusted for purchasing power). Thus the difference in wage levels is approximately somewhere between 5,16 and 14,51 times.

Table 1 represents a comparison of the 2002-2003 productivity levels between the 10 most productive industries in Russia (output volume measured in rubbles per employee) and Finnish companies from the same industrial field (turnover per employee). Such a comparison is difficult to make for many reasons the most important among which is that the turnover is a result of not only labor productivity but also of value-added. That is well indicated by the shocking difference in productivity levels of Fortum Oil and the productivity champion in Russia – the Oil & Gas industry. Another reason for the comparison not to show the exact picture is that the numbers given are for basically successful and competitive Finnish companies (market leaders) against the average values in the case of Russian industries.

Still, the comparison is quite striking as the closest Russian productivity gets to the levels of the Finnish one is in the food-processing sector where the difference is 5,66 times.

The average value of the difference coefficient is 20,2. Even if account the issue of value-added and acknowledge that half the listed Finnish companies are competitive international players the difference remains sadly impressive. Based on these facts one may argue that personnel efficiency is also not among the top priorities of Russian investors. That, however, is of importance not only for the investor itself but also for the national economy as one of its main capitals – human capital is not utilized efficiently or is not properly developed by various continuous education programs.

Respect for the rule of law and relations with institutions

According to Transparency International the cost of corruption is four-fold: political, economic, social and environmental. On the political front, corruption constitutes a major obstacle to democracy and the rule of law. In a democratic system, offices and institutions lose their legitimacy when they are misused for a private advantage. Though this is harmful in established democracies, it is even more so in newly emerging ones. Accountable political leadership can not develop in a corrupt climate. Economically, corruption leads to the depletion of national wealth. It is often responsible for the funneling of scarce public resources to uneconomic causes. It hinders the development of fair market structures and distorts competition, thereby deterring investment. The effect of corruption on the social fabric of society is the most damaging of all. It undermines people's trust in the political system, in its institutions and its leadership. Environmental degradation is yet another consequence of corrupt systems as regulations and environmental norms are ignored (TI, 2006).

How can Russian investments and investors make an impact in this respect. In the 2006 Transparency International Corruption Perception index Estonia ranked 27th, Lithuania 44th and Latvia 51st. In the same ranking Russia takes 126th place (Ibid.). Thus Russian companies, managers and entrepreneurs come from an environment where paying bribes is assumed as normal even if not welcomed part of business procedures. It is not by accident then that in 2002 Russian companies were acknowledged to be among the most active bribers when doing business abroad (TI, 2002).

Without going in further detail it is worth mentioning that Finland and Sweden that are one of the main foreign investors in the Baltic States are accordingly ranked 2nd and 6th by the Corruption Perception (TI, 2006). It is obvious that the business cultural impact of foreign investors could be very important for the long term prospects of the host country to fight corruption and build efficient and non-corrupted institutions. Is it possible to quantify the

⁶³ Information for industrial branches in Russia are taken from AK&M Information Agency that is an independent provider of Russian real time political, economic, financial and stock market news and comprehensive information on Russian Capital Markets.

damage caused by corruption? According to Transparency International the answer is no. One reason is that the related costs are of very complex nature and many numbers often can not be reliably estimated (for instance how much money is invested in corrupted officials).

The unbroken dependency on the Russian state

Are the biggest Russian investors in the Baltic States emitters of official Russian state policies? To what extent have their relations with the Russian state made them dependent on it?

The current ownership of OAO Gazprom shows that the company belongs 38,37% to the Russian state, 36,28% to Russian legal subjects, 13,85% to private persons, 11,5% to foreign investors (*Gazprom, 2004*). Even though that information is not sufficient to understand who actually controls and runs Gazprom (it does not answer who are the legal subjects themselves – private or state owned) it is widely accepted that Gazprom is a state owned company that has natural monopoly over exploration, production and distribution of natural gas.

As such the company's CEO would naturally be the selected and appointed by Kremlin and personally the president. It is not by surprise then that the current Gazprom CEO Alexei Miller is a personal appointment of President Vladimir Putin. Miller is the President's former colleague and, according to experts, his mission at Gazprom is more political, to transmit Kremlin policies, than economic management of Gazprom. It is obvious then that most overseas investment decisions of Gazprom must first have a Kremlin clearance. Such as the decisions to buy in Lithuania the Kaunas power plant and take stake in Lietuvos Dujos. Gazprom also owns a minority package and co-owns Latvia gaze together with the German Ruhrgas and the Latvian government. It is the same system with the Estonian company Eesti gas.

The Russian state owned Transnefteproduct plays a key role in the Russian oil business, since it owns the oil pipe system all producers need to use. Being a serious instrument in the hands of Russian government this company decided to halt oil transport through Latvia and Ventpils for most of the years 2003 and 2004. While the official reason was based on economic grounds it was a common knowledge that the issue had been political.

The financial stability of the Lithuanian oil refinery Mazeikiu Nafta, being the pearl in the crown of Lithuanian industry, was seriously endangered after the former Russian owner Yukos was bankrupted by the Russian state. Yukos is an interesting example as it shows that a completely private company is subjected to such pressure by the Russian government that it turned Yukos from the wealthiest in Russia to the verge of bankruptcy in less than one year. Yukos was internationally recognized as one of the most efficient, market driven and transparent Russian companies. However, Mr. Khodorkovski did something wrong in the eyes of Kremlin and the state demonstrated that it is intent to almost ruin the Russian most successful oil company for the sake of politics.

Lukoil is perhaps the opposite story of Yukos. It is an oil company that is approved by Kremlin where its CEO Vagit Alekperov is in good standing with president Vladimir Putin. Only in July 2004 Russian president Vladimir Putin, ConocoPhillips CEO James Mulva and Lukoil president Vagit Alekperov discussed oil and gas projects during a meeting in the Krasnodar territory (*Interfax, 24.07.2004*).

Still only few years ago the Russian tax police have simultaneously opened criminal charges against Lukoil and its director, Vagit Alekperov for concealing revenues in "especially large amounts." (*GPF, 2000*) The 1995 big scandal surrounding Lukoil and its practice of mixing different gasoline types that brought them additional profit 4,6 billion rubles can easily be

brought back (*Rstaki, 1999*). Bureaucrats are who covered it back then and bureaucrats are who can easily bring it on again. Just as the Yukos case. Is it then possible to foresee if Lukoil will always stay as a favorite to the Russian government? And if not is it possible to claim that Lukoil is a competitive, stable, predictable international player?

As a result it is normal that Baltic politicians worry. The former chairman of the Lithuanian parliament, Vytautas Landsbergis argues "We should avoid such Russian expansion in the energy sector, which is pre-planned, calculated, and which is also part of a political expansion seeking to increase Russian influence in Lithuania. In the past Vladimir Putin has said Russia's policy aims could be achieved by using so-called "energy diplomacy" (*Mite, 2004*)

On the contrary, a member of the Lithuanian parliamentary committee of economics, Birute Vesaite, says it would be silly to build stumbling blocks for Russian capital just because it is coming from Russia. "We have no other way out," Vesaite says. "Who are the main oil and gas suppliers for Lithuania?" Lithuania may have no alternative. That's the view of Nicolas Redman, a Russia analyst at the London-based Economist Intelligence Unit. He says the country cannot afford to buy gas from the West when the Russian product is cheaper and closer (*Ibid.*).

Still, Vytautas Radzvilas, an analyst at the Lithuanian Institute of International Affairs in Vilnius says "there is no doubt" that Russia is seeking to maximize its influence through economic means.

Instead of conclusions

Instead of conclusion the findings of this article could be summarized on the example of Estonia. The biggest share of FDI in Estonia comes from Finland and Sweden. As of 2004 there were 430 active Finnish companies and 264 Swedish companies registered in Estonia. According to the Amadeus data base compiling data between 2002 and 2004 they employ more than 40 000 people or more than 6% from the country's workforce (*Amadeus, 2006*). Together the annual turnover of Swedish and Finnish companies in Estonia amounts for approx, US\$5,94 billion (*Ibid.*) representing a total of 26,7% from the Estonian GDP in 2005 (*CIA, 2006*).

Finland and Sweden are ranked 2nd and 6th in the 2006 Transparency International Corruption Perception index while Estonia is ranked 27th. In the 2006 World Competitiveness scoreboard the Finnish economy was ranked 10th (6th in 2005) while Sweden was ranked 14th (14th in 2005) (IMD, 2006). In the same time Estonia ranked 20th (26th in 2005). It is logical to assume that investors and investments originating from better ranked countries will transmit their business culture and have positive impact on the host country. One argument is the impressive improvement of Estonian ranking in World Competitiveness scoreboard during the last years. Coming from societies where rule of law is a norm, where the state institutions are rather efficient bureaucracies it is only natural they when abroad Finnish and Swedish companies will rather try to apply the same standards and corporate behavior.

Imagine that the Finnish and Swedish investments with their volume and economic impact on Estonia are changed for Russian. Russia is ranked 126th by the Corruption Perception Index (TI, 2006). It is ranked 54 in terms of its competitiveness (IMD, 2006). Russian companies are less productive than their Finnish competitors and that difference is not measured in percentage points but in times. Based on the presented above facts it is reasonable if not to expect than to suspect that if we hypothetically change the current volume of Finnish and Swedish investments in Estonia for Russian then:

- 1) Efficiency and productivity will be at somewhat lower level. Besides bringing lower level of GDP growth this will have also an effect on the long term utilization of resources in general and human resources in particular.
- 2) Corruption will not be treated by Russian investors as an unacceptable phenomenon but rather as a convenient shortcut in achieving certain goals. That will have extremely negative impact as a) corruption will allow for non-efficient allocation of resources of any kind, b) more corrupted environment will attract less FDI and c) state institutions may become ineffectual, arbitrary and disrespected and thus lose their democratic legacy. The rise and fall of Lithuanian President Rolandas Paksas in 2002-2003 could be an example.
- 3) Tangible presence of Russian investments in a country's economy will be certainly used as leverage in Russian foreign politics. The recent Russian economic measures against Ukraine, Georgia or Moldova could only confirm that.

That is why in the case of Finnish and Swedish investments in Estonia Estonians should paraphrase the famous Swedish pop band Abba song to "Thank you for the culture!"

The findings of this paper allow us to reach two interesting conclusions. One is that in evaluating investor's attractiveness from host country point of view much more attention should be paid to "soft" values such as business culture – the main reason being that business culture could be measured concretely in financial terms. The latter certainly deserves much more attention and further research is planned aiming to quantify the impact of foreign investor's business culture.

The second conclusion points to the fact that policy makers should take into account that Russian investments certainly have some side effects that are not limited to the direct object of the investment and may have a much bigger spill over effects that can eventually be somewhat negative and thus outweigh the financial attractiveness of the investment itself.

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Section 4

Experiences of foreign firms on Central and Eastern European and Russian markets

Adaptation and survival of early FDI firms in post-Soviet space: St. Petersburg and Baltic country locations⁶⁴

Harley Johansen⁶⁵
University of Idaho

Anna Panova
St. Petersburg State University, Russia

Abstract

This paper addresses the problem of business survival through spatial or non-spatial (e.g., management and operational) changes in the context of foreign direct investment (FDI) into post-socialist, emerging market countries. In the case of former socialist transition countries, FDI inflow was primarily from the west for labor and other factor cost advantages as we have witnessed during the past decade. This research project examines whether firms become more efficient in their location choice after experiencing the transition and its effect on their operations and markets. A model of the adaptation process is proposed that considers the original FDI location as one made with good information about the new market, or one based on inadequate assessment of the conditions that affected the firm's operation. To study the adaptation process, this project uses survivors from an earlier study of the original FDI firms from Nordic countries that entered the Baltic region (Estonia, Latvia, Lithuania, and St. Petersburg, Russia), in the early 1990s. It compares adaptation trends and reasons with firm characteristics such as size, source country, host setting, and original location decisions. Data from the earlier study are used to compare with current data for each surviving company. The paper describes a set of cases selected from a larger study of Nordic FDI firms, and examines the common elements among these firms in their experience since entering the Baltic region. The surviving companies exhibit adaptive strategies that result from changes in local and national economies, and in the case of the Baltic countries, the entry into European Union, along with local development trends.

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⁶⁵ Moscow, ID 83844-3021, USA; Email: johansen@uidaho.edu

Introduction

The rapid rise of globalization and the associated inward investment to developing countries, often called emerging markets, raises some important questions about location choice and how location is perceived in the investment decision. Foreign direct investment (FDI) involves large multinational corporations with truly global reach, but it also includes many smaller firms that invest in opportunities closer to their home base. This is especially true with FDI into countries that emerged from the former Soviet Union (FSU) and other socialist republics in central and eastern Europe (CEE), where cross-border investments from neighboring western countries such as Germany and Finland were common (Pavlinek and Smith, 1998; Michalak 1993; Estrin et al., 1997; Tornroos and Nieminen, 1999). Location decisions and strategies vary with the scale and global reach of FDI companies, as does the ability to risk capital in situations where information is lacking. Where initial location decisions are later discovered to be less than viable, we should expect firms to adapt by changing locations if this becomes possible and practical. We should also expect tendencies toward spatial order in aggregate location decisions, as we attempt to model business location behavior. Spatial shifts toward, e.g., clustering might be observed and these tendencies might be categorized by firm characteristics such as size, source, type, history in the region, and other dimensions that could explain locational behavior.

In the broad view of development, location affects competitive advantage through its influence on firm productivity and productivity growth (Porter, 2000). As the aggregate of company productivity, an economy's sustainability will depend on companies' adaptations to changing conditions within the economy. Adaptation may be in the form of intra-firm adjustments and/or through change in location of the company operations. Understanding both forms of company adaptation in the context of FDI is potentially very useful to further our understanding of business location behavior and to enable successful development policies of transition countries as well. Using a set of companies that made investment decisions in an emerging market setting about ten years ago in the Baltic region, this study examines adaptations that surviving companies have made in the subsequent years as the transition to market economy occurred. It looks at both management adaptations and location adaptations to see if observable patterns or tendencies can be identified, and if these adaptations can be explained by conditions of information and experience that are related to firm characteristics.

Spatial and non-spatial adaptation, and the transition country setting

Established theory explains FDI, in part, as a response to differences in the costs of factors of production due to relative factor endowments, which vary between countries, and the OLI paradigm of ownership, location, and investment advantages associated with FDI (Dunning, 1998). Expansion by multinational corporations will typically be located abroad with headquarters in capital abundant countries and production in labor abundant countries. In the case of FSU and CEE transition countries, this favors FDI inflow from the west for labor and other factor cost advantages and we have evidence of this from empirical studies. A further advantage of countries such as Poland, Hungary, Czech Republic, and the Baltic countries has been their European Union candidate status, which put these countries in the EU customs union, thereby eliminating disadvantages of small market and market entry barriers (Hein and Vork, 2000). A Baltic country location can now provide market access that was lacking in the early 1990s and may have shifted the orientation toward Europe as opposed to the earlier "gateway to Russia" perspective expressed earlier by some western companies (Johansen et al., 2001).

One might expect that firms should become more efficient in their location choice after experiencing the transition and its effect on their operations and markets, yet adaptive behavior in ex-socialist settings has received minimal attention in the literature, probably because we are now just a decade away from the first major wave of FDI into much of the

CEE and FSU region. In a paper on information and learning behavior of firms in this context, Arvidsson (1999) distinguishes between learning by the western firm and state-owned enterprises. His model for the typical FDI western firm is called single loop learning, whereby a firm uses information to improve operations in a continual feedback loop such as:

task (experience) → reflection → task improvement

This orientation toward improved business operations and goal achievement can include the range of experience related factors, but it could also include the assessment of the firm's location and how this might be improved, similar to operational tasks or management. We need to look at how location is viewed by the firm in the context of FDI into a new region. Below is a list of possible perspectives:

Location Context – Possible perspectives of FDI Firm in Emerging Market Region

Regional – e.g., Baltic vs. other CEE and developing regions?

Intra regional – which country(s) to enter?

Intra country – which city(s) to enter?

Intra city – which site within urban area?

As we know from previous studies, many factors influence a firm's choices within these location alternatives. The initial decision will reflect the whole range of firm, and personal experiences and available information relative to each potential host country and available site within each country (Chapman and Walker 1991; Tornroos and Neiminen, 1999).

A relevant framework for this study lies in the behavioral approach to business location theory that centers on the balance between the goals of the firm and the quality and quantity of information about current and potential locations as proposed originally by Pred (1967). Under conditions of uncertainty and/or inadequate information, firms will either fail or (to survive) must be "adopted" (read accommodated) by the system, or "adapt" through management or location changes (Alchian, 1950; Tiebout, 1957; Chapman and Walker, 1991). In reality, companies operate with imperfect knowledge and make decisions to reduce risks and meet profit goals satisfactory to their owners or shareholders and directors. Companies that invested in a new frontier-like emerging market such as opened up in the ex-socialist CEE and FSU region after 1991, perceived new opportunities but many had relatively little reliable information about market conditions and possible locations. As an example, the Finnish oil company Neste made location decisions for their service stations based on spot traffic counts that they quickly assembled themselves at various parts of the Baltic cities. In Lithuania, they even resorted to portable modular stations for test marketing locations. These stations could be moved if the location didn't prove successful (Johansen, 1995).

Firms that chose good locations may have had good information and decision capabilities, but firms that did not choose well (and survived) should theoretically, have either been adopted or they will have adapted to their inadequate location in some way. The question here is how early location choice affected firm survival during the decade of transition? Was survival related to firm size, investment type (joint venture or greenfield), source country, industry, or other factors? If location was not a recognized factor in firm survival or failure, what were the conditions that required adaptation? Information on failed firms is difficult to obtain, but survivors are expected to have experienced a range of stresses that required adaptive strategies that may have prevented failure. Failed firms may have commonalities that will emerge when a list is compiled to compare them.

Spatial adaptation through clustering

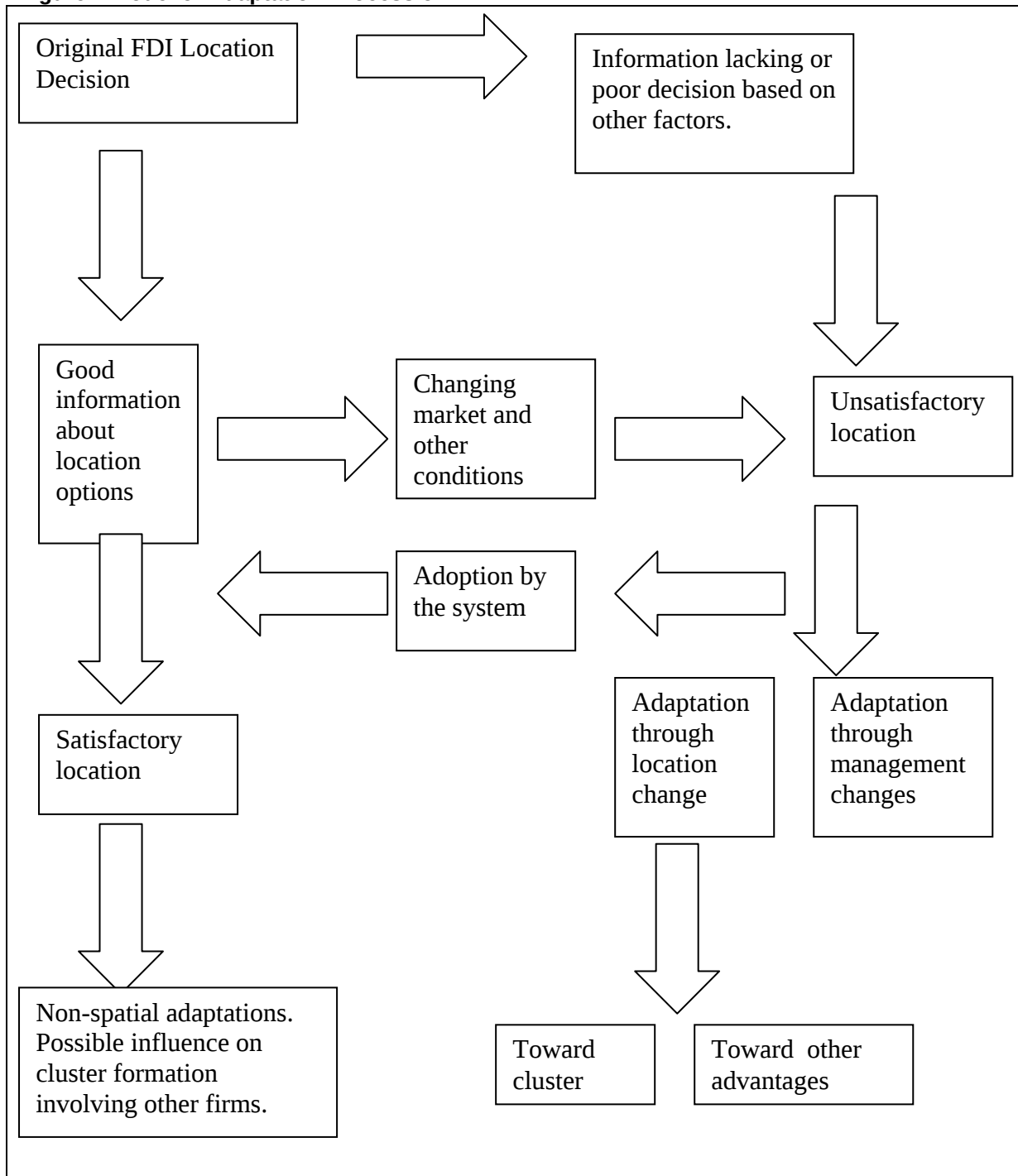
More recently, company strategy has been viewed spatially in the context of clustering, as a way to increase competitive advantage (Porter, 1990, 2000). While clustering resembles the earlier concepts of agglomeration, and associated external scale economies, it is now seen as broader in scope than just cost minimization, yet it still is most easily applied to firms engaged in production activities including manufacturing and producer services. Current discussions of industrial clusters do emphasize “non-market forms of interaction, including non-traded interdependencies” (Glasmeier, 2000), and “clusters as expressions of social connectivity rather than mere spatial agglomeration” (Van Dijk and Sverrisson, 2003) and these dimensions seem especially relevant to FDI locations in transition countries where networks of foreign investors are important. As an example, our earlier study revealed numerous cases of interaction between western firms in the Baltic cities even though the companies had no apparent connection related to their business operations. Associations such as American Chamber of Commerce in St. Petersburg, and similar organizations in other FSU cities helped firms learn from each other and even helped to make local lawmakers aware of the concerns and interests of these firms. Whether these business networks have led to spatial proximity is yet to be determined.

While industrial clustering (and promotion thereof) is now considered a strategy for economic development (Glasmeier 2000), we must realize that clustering in some sectors, such as retailing has been recognized as critical to business survival throughout history, whether in periodic markets or in permanent shopping centers. How then do firms in different sectors view the advantages of clustering as part of business strategy? If location is important to the firm’s viability, it should be reflected in adaptive behavior where this is possible, and clustering might be a collective form of adaptive behavior as suggested in the literature (Porter, 2000; Glasmeier, 2000). To set the framework for this project, it is important to consider the transition process in ex-socialist countries and how business location factors of consideration evolved during the first decade since it began. We should expect that not all companies have survived the first decade, and that some will have re-formed into new enterprises through new partnerships and new ventures as they adapted to changing conditions.

In theory, investment decisions and location decisions will vary among FDI firms by size and resources of the firm and their experience within the region. In the Baltic region, some larger firms in neighboring Nordic countries had prior experience in the Soviet Union and knew about manufacturing plants that were available for privatization, or about contacts in, or familiar with the region that could provide reliable assistance. Smaller firms, on the other hand were more likely to be dependent on first-hand observation and information from the fledgling government development agencies in the early years.

A proposed model of the adaptation process is shown in Figure 1. The original FDI location may have been made with good information about the new market, or it may have been based on inadequate assessment of the conditions that affected the firm’s operation. Either way, a firm can choose a good or a bad location, resulting in the need for adaptation through management or location change, unless it becomes “adopted” by the system. In the case of adoption, a firm may be lucky with a location that becomes satisfactory despite lack of information or analysis of location factors. The decision to stay in place or move to another location will be made on the basis of current market and operations assessments.

Figure 1 Model of Adaptation Process of FDI Firm



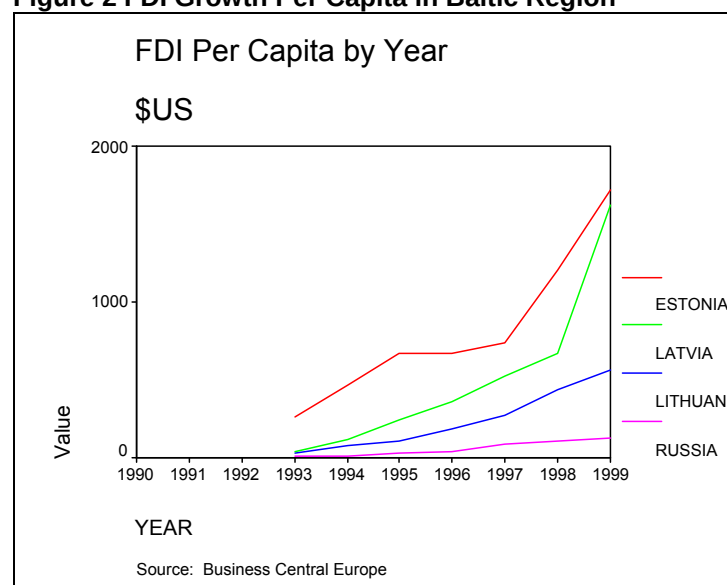
We can assume that a firm's understanding of market and demographic trends since independence will accrue from the firm's experience in the transition country setting, making each successive new or re-location with better information. Adaptation to location disadvantages can result in either spatial adaptation or compensation through other means. If relocation occurs, it could be because of better assessment of the existing market conditions and/or because market or other factors, e.g., transportation infrastructure or institutional factors, have changed since the original investment was made. Spatial adaptation may result in tendency toward clustering where external factors are recognized as important, or an early firm's original location could become a nucleus for clustering by other firms, both FDI and local. This pattern was seen in the case of Neste, where a new cluster of automotive related local firms emerged around the original site of Neste's retail outlet and office headquarters in Riga (Johansen, 1997). Adaptive decisions can therefore

involve both internal and external factors and will reflect a firm's experience and assessment during the years following the initial FDI decision.

Research Problem and Background on Test Region

Foreign investors began entering the post-socialist emerging market countries as soon as the wave of independence began in 1991. The inflow to the region continued to grow in volume and relative to GDP and per capita throughout the 1990s decade (Figure 2). In the early years of this new wave of business location, much was lacking in terms of information about market characteristics including demographics, traffic flows, consumer demand, and competition. It was a frontier-like atmosphere with decisions being made on observations, estimates, and with minimal data. In fact, location seemed less important than just being in the country or especially, being in the capital cities of these newly emerging nations (Johansen, 1995).

Figure 2 FDI Growth Per Capita in Baltic Region



How then have these initial site selections fared as the transition to market economy developed during the past decade? Have companies that made location decisions in 1992 or 1993 been influenced to change these locations? And if so, what factors led to the need to change location? Are the location factors considered similar to those in western countries, or do transition countries require other considerations? Are spatial and non-spatial adaptations related to characteristics of firms that reflect sector, size, ownership, host country, or other factors? And are spatial adaptations made by surviving firms influenced by external factors such as economies due to agglomeration, and has this led to recognizable clusters of either FDI or local firms since the transition began?

The previous study revealed several regularities in company motives to move to the Baltic region and in their choice of location within the region. Actual site selection was often less carefully considered by the companies than which countries and cities to consider. The availability of office space and commercial properties within the region in the early 1990s was rather limited and many buildings were being renovated (an important FDI opportunity in itself) to meet "western standards" throughout the Baltic capitals. Other location considerations concerned which cities to enter and how best to serve the emerging market in terms of strategic locations within the region.

In the early 1990s, Russia was seen as the market with big potential but high risk, by many investors who considered the Baltic countries to be a safer "gateway" to their eventual target.

Inside Russia, the decision to be in St. Petersburg was seen by several Nordic companies as a gateway to the rest of Russia yet a safer location than in Moscow, or other interior cities. Today, that decision may be viewed quite differently as Moscow has become the economic center of the new Russia and with the emergence of interior cities such as Ekaterinburg, Samara, and others as market opportunities expand (Hanson and Bradshaw, 2000). Given the multitude of questions facing the entering company in the beginning, it is quite likely that less than optimal sites and locations were selected in the early years and that companies have reconsidered their location strategy where important problems or opportunity costs can be recognized. If we segment the FDI companies by sector, we can speculate as to how these location issues might have played out during the decade. As shown in Table 1, most companies were in trade and service sector, followed by manufacturing and construction and only a few in the primary sector (mining and forestry).

Table 1 Industry Sector of Responding Companies (Nordic FDIs, 1995)

Sector	Estonia	Latvia	Lithuania	St. Petersburg	Total
Primary Production	1	1	0	0	2
Mfg. And Construction	22	8	7	3	40
Trade and Service	23	16	12	14	65
Total	46	25	19	17	107

Source: Survey of firms (Johansen, Snickars, and Steinbuka, NSF project INT-9401940).

Data and Methods

The unit of analysis for this project is the FDI company with Nordic origins, in the Baltic region, and includes the complete list of 107 companies that responded to our initial survey in 1995. Aside from the longitudinal dimension of the study, there is an advantage to limiting the survey to these companies because we have a history of prior contact and cooperation with these firms. A survey of company managers was administered via email where possible, and post, fax, or telephone interview where necessary. The survey was administered in several formats, including two internet website versions (long and short), email to company addresses, regular mail to company addresses, and via telephone. Responses to this survey were limited and did not provide substantial evidence of firm survival or behavior to satisfy us that we had a valid data source to test our model. Therefore, we moved to site visits with known survivor firms, and a few additional companies that entered the region in the early 1990s, but were missed in our earlier study.

Expectations:

- Manufacturing firms will be more stable in location than retail and service firms. The reason for this expectation is because Nordic manufacturing firms were all of the privatized type, i.e., no new “greenfield” plants were built by the early companies. Therefore, these companies acquired their location along with the plant and are more likely to have kept it. They may have adapted to location disadvantages, however, by later acquisitions in better locations, or through expansion or new plant construction at other sites. The scale of these location changes will be dependent on market, material, and labor conditions as in normal manufacturing operations.
- Surviving retail and service firms will exhibit spatial adaptation for various reasons, including: responses to market area changes, location of competitors, emergence of retail clusters, transportation changes, demographic changes within the market area, and/or better understanding of the market and demographic patterns.
- Where the early retail and service firms chose good locations initially, we can expect these will have led to clustering in some cases. Both local entrepreneurs and other FDI firms may have followed the early firms, influenced by their early site selection.

- Some retail and service firms will have moved to new market locations in other parts of the cities (intra-city), to other cities (intra-country), and to other countries in the region (intra-region), as they developed during the years since their entry.

Surviving Companies

Determining surviving companies was more difficult than originally planned. Many companies have become impossible to trace via telephone, email, and internet sources, and listings of existing companies by name may miss those that have changed their name or merged into other companies. We used all of these methods to try to get the list of survivors in each country, and we are still not sure of the accuracy of our results. According to our responses and confirmed addresses (internet, telephone, or postal), we estimate that of the original 107 Nordic companies listed as of 1994, approximately 45 percent of these have survived in recognizable form as the same companies, or with documented changes of name or affiliation (table 2). The survivors seem to represent all sectors and companies that had stronger footing in the beginning of the transition. Small entrepreneurial partnership ventures seem to have been less likely to survive than larger FDI firms.

Table 2 FDI Company Survival Rates by Country, 1995-2005

Estonia	50%
Latvia	46%
Lithuania	25%
St. Petersburg	50%
Total	45%

Most companies added employment during the time interval of about ten years, and this was quite a large increase of over 3300 jobs overall. Employment change by sector is shown in Table 3. Manufacturing firms added the most jobs, followed by construction and transportation.

Table 3 Employment Growth by Sector

Industry	N	net 1995-2006	Mean job growth per firm
Construction	2	335	167
Manufacturing	7	2572	367
Retail	3	27	9
Service	4	122	31
Transport	1	278	278
Wholesale	2	14	7
Total	19	3348	176

Source: Visited companies, 1995-2006.

Location changes were common among survivors and the reasons for change vary, but lean toward a need for more space to accommodate growth, or for logistical purposes. Manufacturing firms were less likely to have changed location, as expected. Interviews with selected surviving companies provided some examples of adaptations made by companies of various size and type. Specific examples from the surviving companies are listed in Table 4.

Summary of Company Interviews

Site visit interviews with 20 companies were conducted to learn about their business since entering the region. All but three of these companies had been visited in 1996, and several in St. Petersburg had been visited again in 2001. The companies visited represent different size and sector categories, and all were either partially or fully owned by Nordic investors at the time of their entry into the ex-Soviet Baltic region (Table 4).

In St. Petersburg, we interviewed eight companies in September of 2005. These included a variety of firms engaged in sales, service, construction, manufacturing, and shipping. The reported adaptations included both location and operational changes to improve efficiency and increase profits. The companies interviewed emphasized the many changes that have occurred in the St. Petersburg market, especially since the rouble crisis of 1998. They describe sacrifices made during the crisis to survive, and how these strategies have enabled them to be stronger in the post-crisis era. A major increase in demand for new and renovated housing and commercial space provides strong growth support for some companies, e.g., Lentek and Betomix, and increased household incomes have led to better consumer market support for other companies such as Roxor and Tetra Pak. In all cases, location assessments have been made and changes (or expansion to new locations) were made in all but one of the companies (Table 4).

Estonia's economy is in a fast-growth period. First quarter growth in 2006 was 12%. This has led to nearly zero unemployment in the Tallinn area and 2% nationwide. Real estate in Tallinn is a booming market and structural funds from EU have fueled construction projects for infrastructure. All of this supports the local construction economy and related industries. Companies are seeing a challenge to keep employees and therefore a need to increase compensation and encourage employees to stay with them. Competition is keen in the labor market. This is highest in the Tallinn area. Ireland and other EU countries attract labor away from Estonia with higher wages. Company survival was associated with an ability to survive the Russian rouble crisis in 1998. This affected the Estonian economy deeply and caused a need for adaptation with new strategies by firms here. Now with rising labor costs, productivity must increase to enable higher wages to be paid in a small market. Market expansion in Estonia is not seen as a great potential for growth, so productivity growth and export are left as opportunities for increased company profits. Mistra Autex, Kunda Nordic Cement, and Pomorfin are examples of manufacturing companies that have survived the transition and have increased productivity amidst rising costs, and have expanded their markets through connections to Europe. Mistra Autex worked to meet high standards of automotive supplier requirements and landed contracts with Volvo and other companies. This completely shifted its market from old Soviet companies to European companies. Pomorfin shifted production from its plant in Finland to Estonia and has used clever technology and internet marketing to expand sales world-wide. This firm has increased productivity through adaptive technology and marketing. Kunda Nordic Cement is now owned by Heidelberg Cement Company and has gained market network and capital for production investments in this way. Their development of the port has led to growth in this sector of the company and to attraction of other firms to Kunda in forest products and other resources. The growth of Estonia's domestic market for cement changed the company's strategy from export of clinker to increased sale of final product cement. Profits have allowed the company to invest in the fourth? kiln to enable increased clinker production for export to Russia.

Latvia has experienced similar trends as in Estonia. The companies mentioned similar competition for labor and rising labor costs. Many Latvians now live abroad in Ireland and other western European countries, including Norway. Latvia was also hit hard by the Russian rouble crisis and the loss of export market in Russia. Competition for labor and market share has increased here, as in Estonia. Latvia is also a growing real estate market and a housing boom is driving growth in companies, including Electrolux, where sales have doubled in about three years and continue to grow in the Baltic region. Tetra Pak is still

working to gain market share in their dairy packaging line, and it will depend to some extent on consumer preferences toward packaging. Plastic pouch packaging now is their main competing industry.

European Union Effects

The Baltic countries are still viewed as a small market, and one that is maturing along the lines of Western Europe and global trends. These countries joined European Union and thereby became oriented toward the west in an official way that probably increased stability and solidified their image as safe investment markets. While most of the companies say that joining EU did little to influence their business operations, most agree that it did have significant indirect effects, such as bringing additional funds to support investments in infrastructure and entrepreneurial programs, and that the real estate market was expanded with EU entry because it allowed real estate to be owned by investors from throughout the EU region. This has created a real estate bubble that could have limited long-term effects, depending on how lasting it proves to be. The construction sector, along with tourism is driving growth here and the rising wages and labor costs.

Table 4 Adaptations of FDI Companies in Baltic Countries

Estonian companies

Company	Location Change	Operational Change	External Factors
Mistra Autex (manufacturing automobile components)	In same original factory location. This is satisfactory space, but presents problems with local labor supply. It is a commute from Tallinn and the local village is small.	Attained ISO status to meet first-tier contract specifications for Ford, Volvo, and other auto companies, including TS 16949, ISO 14001, and Ford Q1 supplier status.	EU entry helped shift focus to west; Russian rouble crisis and car industry decline also important.
KPMG (service)	Will now move to new business center, same location in Tallinn center. Important to be near hotels and office headquarters. Added offices in Tartu, other cities.	Client base expanded and includes 50% local companies. Also serving clients in Russia from Estonian offices. Employment growth over 100%.	EU entry did not bring many changes because KPMG was using international accounting standards in pre-EU times. Estonia is still a small place and is not so cheap anymore. Labor costs are serious issue. Real estate market is strong. Service costs are also increasing. The Russia connection was hurt by the rouble crisis, but things are picking up today for Estonian companies interested in Russian investments.
Kunda Nordic Cement (manufacturing cement)	None	Expanded production of finished cement and clinker. Adding new kiln to serve expanding market.	Bought by German co. This expanded market links and added capital. EU indirectly important through construction growth.
People Management (human resource services)	Moved within central Tallinn to location with better parking.	Focus shift from human resource consulting to recruiting "head hunting" services for corporate offices.	Human resource market changed with increase in western style business practices. Competitive labor market.

Table 4 continued

Company	Location Change	Operational Change	External Factors
Pomarfin (manufacturing shoes)	No, but shift of operations from Finland to Estonia.	Major expansion of market to Global scale with internet and other technologies. Focus on quality production of custom fit shoes.	Internet growth made custom manufacturing possible. EU membership helped streamline customs process.
Prolexplast (manufacturing office supplies)	None. Good location selected at beginning, near Tallinn, but outside congested area in old kokholst that produced chickens. They renovated the plant.	Came in 1991 as new company, similar to a plant in Finland at that time. Added additional lines of production. Expanded from five to 28 employees.	EU membership not a major factor, but simplified some supplier issues and customs procedures. Marketing to EU via Frankfurt fair important.
GNT Estonia (wholesale electronic equipment, computers)	Move to new warehouse facility on edge of city to combine office and warehouse, and to get larger space.	Microlink split to form this company. GNT formed from CHS to do distribution and sales of computer technology and IT products, and home electronics, laptops. Offices in other Baltic states. Back office work moved here from Nordic countries.	Expansion of GNT to other countries in Europe. Growth of market with EU entry in 2004 (38%), steady growth of office and home electronics market.
Elcoteq (manufacturing communications equipment components)	Estonia location chosen because it was close to end market (Nokia and Eriksson) and had similar labor advantages as Asia. Estonian government encouraged location here with incentives and investment capital. Finnfund also invested. Elcoteq stayed here because of low, flat taxes and good business climate. Also technical schools here. Added plant in St. Petersburg in 1997.	Change from complete mobile phone production, to components for multiple clients. More flexibility in production design introduced, and in production management and labor force contracts. Labor cost is still an advantage here, but they are rising. Productivity is good (more than doubled since 1997) and must continue to increase with wages.	EU entry increased some paperwork, but reduced problems at the borders. IT stock bubble burst in 1999, caused Eriksson to sell some plants and cancel orders. Elcoteq had to lay off workers. Now they are back up again.

Table 4 continued

Latvian Companies

Company	Location Change	Operational Change	External Factors
Price Waterhouse Coopers (service)	Remained in Central Riga. Moved to larger office space.	Expanded client list to include a majority of large local companies along with multinationals. Most employees local now. Added offices in other Baltic cities. Employ about 100 in each Baltic country.	EU entry opened borders, made legislative changes, and labor market opened up. Real estate market expanded causing market growth. Russian rouble crisis of 1998 caused some companies to fail, especially in Lithuania.
Tetra Pak (manufacturing)	Moved to new office to gain space in 1999, but remain near center of Riga.	All Baltic operations are now directed from Riga. The Baltic operation is small and primarily involved in packaging dairy, juice, and nector market, along with soft drinks. Emphasis is on efficiency. Small farms are still common here and get EU subsidy. TP works with customers on total market solutions, including analysis of consumer tastes and market trends.	Restructuring of dairy industry in 1990s caused loss of business. Milk packaging in cheaper plastic bladders became the dominant competitor here. EU entry brought subsidy for small farms, slowing the consolidation of dairy farming in the Baltics.
Electrolux (sales and service)	Moved in 1999 to get away from congestion in central Riga. Still in the city.	The company is now the established market leader for imported appliances. Sales doubled in past five years. Dealer network in Latvia is managed from Riga. Customer relations are important here. Electrolux is in the premium market sector and they do not try to serve the low-end market. After-sales service is important and grows along with sales.	EU entry brought standardized laws and it is easier to move goods now. EU entry also responsible in part, for real estate boom, which boosts appliance sales.
Alfa Laval (manufacturing and service)	Moved in 2006 to new space in same building. They like their central Riga location.	Hired locals, as planned earlier. Expanded market to include breweries and baking equipment technologies sales and services.	EU made delivery of goods easier, with fewer customs regulations. Now in Baltic and Poland division of Alfa Laval.

Table 4 continued

St. Petersburg Companies

Company	Location Change	Operational Change	External Factors
Norvica (travel agency)	Moved to separate office building near Finnish consulate. This is second move after first location in Astoria Hotel, and later office on Kazanskaya street, following that. They now own the building they are in.	Offering normal travel services. Serving mainly corporate clients, including many Russian subsidiaries of Finnish companies. Management purchased the company from Finnair and transformed the business into an independent agency. They had to change the name (Finnair requirement) but were able to keep their clients and their staff. It is now a stock company with shareholders from Russia and other countries.	Parent company decision to release the travel firm. Growth in outbound travel following the rouble crisis in 1998 has improved the market.
Containerships (shipping and delivery)	Moved in 2001 from inner harbor site to new facility in Kronshtadt, on island on the ring road, soon to be completed around St. Petersburg. They also moved their office to Yshakovskaya Naberezhnaya, within the city limits on the road to Kronshtadt. The company has moved both its port facility and its office to better locations since coming here in 1993.	Containerships provides door-to-door delivery of cargo. The company owns its own trucks, ships, and other vehicles, but they use subcontractors also. Inside Russia, the containers are delivered mainly by trucks. These operations have not changed significantly since they entered Russia. Market growth has led to expansion of delivery area. Survived crisis because of their early purchase of port facility and their container import and delivery networks. Move to Kronshtadt will eventually reduce travel time to Moscow and interior Russia.	Development of ring road plan and construction. Growth of Moscow and St. Petersburg real estate markets. Crisis in 1998 reduced cargo shipments. Subsequent growth in Russia led to annual growth of 30%.

Table 4 continued

Company	Location Change	Operational Change	External Factors
Lentek (construction)	In same location since entering Russia, on main road from Finland to St. Petersburg. Have expanded operations in Russia to Moscow, Kazan, Samara, and other locations.	Have adapted by successfully bidding on larger projects, including factories for Ford, Nokian Tires, Philip Morris and others, along with hypermarkets and other major commercial buildings. They entered housing market as developers of several large apartment complexes in the city. Employment growth of 100% since 1997, after a reduction during financial crisis.	Russia's financial crisis of 1998 was the major factor in Lentek's operations, but the situation is very different now. A new construction law puts greater expectations on construction companies.
Betomix (concrete mix manufacturing and sales)	In same location as original, but have expanded to add new plants around the city.	Survived the 1998 crisis and now have established reputation for quality concrete and reliability of delivery. They are now owned by large multi-national company CRH, with plants in Ukraine, Baltic states, and elsewhere.	Crisis in 1998 was very serious for construction industry. Betomix had to reorganize to survive. They remained in production and have resisted the opportunity to join the housing construction industry, because they don't want to lose their construction clients.
Kinnarps (office furniture sales)	Moved to larger facility within St. Petersburg.	Concentrated on high end western company office furniture market. Focus on quality imported furniture.	Growth of competition in furniture market from large importers for household market.
Marketpoint (advertising)	Moved to facility within the city, but in a nice area near center.	Merged with another marketing and advertising design company. Focus on promotional activities for western and Russian clients.	Competition from Moscow firms in advertising business.
Roxor (import sales)	In same location as in 2001. Expanded space to meet needs of expanded company	Added new lines of business to earlier imported household supplies division. Focus on catalog sales of light industrial goods throughout Russia.	Rouble crisis caused most severe impact on the company. They sacrificed to survive.
Tetra Pak, St. Petersburg (manufacturing/packaging liquids)	Moved to larger office facility in central St. Petersburg to manage the northern operations in Russia. It is a branch of the Moscow office.	Continued to offer packaging of liquid products throughout Russia. New venture to box wine, imported to port facility in Vipuri. Box wine is new concept in Russia, and they hope it will be adopted along with Russian taste for imported wines,	Dairy industry reorganization affects opportunity to develop packaging contracts in the St. Petersburg area. New growth in wine market seen as opportunity for boxed wine.

Source: Interviews with company managers.

Conclusions

It is clear that early FDI companies into the ex-Soviet Baltic region have adapted through both location changes and through operational shifts, including many changes in product or service lines, and the ability to survive during the early transition period was probably due in part to these adaptations. Companies have seen major changes in their Baltic markets as incomes increase and tastes change, and they have used their relatively low cost setting to expand into export markets beyond the region. Many examples of European Union effects were seen where growth has been spurred either directly or indirectly from EU expenditures in the Baltic countries. This is especially apparent in the real estate market, but also in ease of shipping across borders and increased visa-free tourist travel to the Baltic capitals. At the same time, growth in Russia has revived some market opportunities for Baltic companies to look east, and there are many examples today of FDI companies in Russia coming from Baltic source countries. The labor shortage in Tallinn and Riga is good evidence of growth and increasing opportunities and prosperity among Baltic residents. Labor competition has raised labor costs for Baltic companies and may eventually remove one of their most important cost advantages, if productivity growth does not also grow here. Continued success of FDI companies will depend on productivity and adaptation as the Baltic area continues to evolve into its own economic and cultural region within the global economy.

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Sources of competitiveness related to foreign direct investment of a Finnish construction company Ukraine

Kaisa-Kerttu Hannula⁶⁶

Valtteri Kaartemo⁶⁷

Turku School of Economics,

Pan-European Institute

Abstract

This paper studies the determinants of foreign direct investment (FDI) and sources of competitiveness of a Finnish case company operating in the construction sector of Ukraine. Construction is a growing sector in Ukraine and offers opportunities for foreign companies looking for new markets. It is therefore interesting to study the determinants leading to the competitiveness of a foreign company which has successfully operated in the markets already for several years and attempt to determine the different aspects affecting the decision to engage in FDI in the host country.

The theoretical framework of the case study views the determinants of FDI from the perspective of competitiveness. In order to study the competitiveness of a company in a host country the asset-exploring and exploiting motives of FDI are combined. The business operations and investment decisions of the case company are analysed by means of OLI paradigm and competitive advantages addressed by Porter among others. Also the role of networks and strategic alliances in the internationalisation of construction business is considered in the analysis.

The pilot case study shows that the importance of local knowledge and networks in the local community are crucial for the competitiveness and success of the company's international operation. The company possesses technical knowledge of products which are superior to the local counterparts, but in order to be able to use the assets the company finds it as important to have local presence with local managers and networks. This suggests that FDI may make construction companies more competitive in the host market relative to companies that solely rely on their existing competitive assets via other modes of internationalisation. In the future, more information is needed, how the local presence and local employees help companies to become more competitive, and in turn how their presence affects the competitiveness of indigenous companies in the market.

⁶⁶ kaisa-kerttu.hannula@tse.fi

⁶⁷ valtteri.kaartemo@tse.fi

FDI in Ukraine

Ukraine provides foreign companies with a large potential market combined with relatively cheap resources and labour costs. Foreign direct investments to the country have, however, remained relatively low due to the challenges of the investment climate. One of the most critical problems in Ukraine is high corruption rates and the country was ranked 122nd among 146 countries in the corruption index of Transparency International in 2004 (Transparency International 2004). Outdated legislation, bureaucracy and poor corporate governance also create problems for foreign companies (EBRD, 2006). Ukraine provides an example of a demanding transition economy environment for Western companies entering the country and studying foreign operations in Ukraine can offer interesting information concerning the problems in this context.

Foreign direct investment flow into Ukraine is claimed to be one of the lowest among the CEE countries. Despite the attractiveness of the market in terms of growth potential and scale, the FDI has remained modest. FDI inflow to Ukraine has been quite stable during period 2003 to the end 2005. The quarterly average FDI inflow has been around \$500 million. The FDI stock almost doubled during 2005 compared with 2004 due to large scale investments made by Raiffeisen Banking Group and Mittal Steel. FDI stock in Ukraine also grew to over \$16 000 million in 2006 from \$9000 million in the previous year. (State Statistics Committee, 2006.)

About one third of total FDI inflows to Ukraine originate from Germany, followed by Cyprus and Austria. The high share of FDI from Cyprus to Ukraine can be explained by reinvestments of Ukraine's own capital. The highest share of investments has been made to trading sector. The investments to metallurgy were quite moderate before the large investment by Mittal Steel in 2005. The other more attractive sectors for FDI have been food industry, mechanical engineering, transport and telecommunication, financial sector and petrochemical industry. (Invest in Ukraine, 2006.)

Finnish investments in the country have so far been quite modest. According to the State Statistics Committee of Ukraine the volume of Finnish FDI reached \$ 9, 2 million in the beginning of 2006 growing by 1,5 million from previous year. Finnish exports to Ukraine grew by 21% in 2005 and amounted 311 million euros (National Board of Customs Finland, 2006). The majority of Finnish exports to Ukraine consist of machinery, equipment and transportation devices. Imports from Ukraine to Finland are quite modest and consist of manufactured ready made goods as well as fuels. According to Finpro Ukraine there are currently around 50 Finnish companies operating in the Ukrainian market either by local subsidiaries or representative offices (Oliinyk, 2006).

Construction material sector in Ukraine

Construction is growing in Ukraine and for example the investments in fixed capital within the construction sector in the country grew by over 40 % in the first quarter of 2006 compared with the previous year (State Statistics Committee of Ukraine, 2006). According to Engineering News Record (2006) in 2004 out of world's 400 top contractors four operated in Ukraine, namely Bechtel, CH2M Hill Cos. Ltd, Perini Corp and Washington Group International Inc. Foreign investment inflows to the sector have remained moderate, and accounted \$26 million and \$48 million in Ukraine in 2003 and 2004, respectively (UNCTAD 2005). Growing construction activities result in increasing demand for construction materials. Construction materials constitute a \$2.6 billion market, and the sector is growing rapidly (Ukraine Trade Invest, 2006). There are already several companies with foreign investment in the market, and these companies generate a substantial amount of sector revenues.

Domestic sales account for majority of the sector revenues and are growing at a rate of 20 to 40% per year, depending on market segment. Natural resources available provide the

sector with a major competitive advantage. Relatively low cost skilled labour and low electricity costs are also important competitive advantages. These advantages give brown field investors solid opportunities to generate high ROI. The existence of strong sector leaders presents good prospects to strategic partnership investors as well. (Ukraine Trade Invest, 2006.)

Ukraine's economic development and its current negotiations with World Trade Organisation (WTO) make it an interesting target country for international construction companies. As noted by Ngowi et al (2005, 139) construction demand can be determined not only by investment and economic growth, but also by the stage of economic development of a particular economy. Furthermore, while it has been established that a large portion of construction activity remains local, regional or national at all stages of development, on the other hand, the protocols of WTO are aimed at eliminating these distinctions by removing the barriers that hinder foreign companies from participating in previously regulated local markets. Globalisation and the increasing competition thus pose both opportunities and threats for Ukraine's construction markets. As trade barriers are lifted indigenous companies are forced to comply with international standards and must increase their competitiveness in terms of cost, quality and project delivery (Raftery et al. 1998, 733).

Ukraine has a fairly well-developed construction materials industry. In the past few years, annual growth of construction materials output has been 10-12%. Production is spread across the country in enterprises representing many industrial sectors. There are more than 32 thousand plants, firms, and organisations manufacturing construction materials and employing more than 1 million workers. Construction materials industry is mainly concentrated near sources of raw materials in the eastern parts of the country and regions with high construction activity rates such as the capital region. (Ukraine Trade Invest, 2006.)

Most of the local roofing and insulating materials are inferior to imported ones in appearance and durability. This lag is mainly due to an insufficient level of production technology, equipment and the need for designing and implementing investment and innovative projects. Some regions still have a shortage of many construction materials. The sector of building materials and the construction industry in Ukraine have certain challenges, which should be developed in order to be able to increase the profitability of the sectors. One of the challenges is changing the structure of construction materials production to meet the needs of modern construction and introduce new kinds of architectural and building systems as well as construction types and technology. Creating a regional network of wholesale and retail organisations is also needed. (Ukraine Trade Invest, 2006.)

High-end roofing materials became available in the country a few years ago and since then, demand for these formerly elite materials has developed quickly. For many decades, in the cities of Ukraine and Russia, the majority of roofs of country houses were covered with asbestos cement sheeting and galvanization. Since the new products have entered the markets, new roofing trends are constantly introduced. Metal tile for example is a rather young roofing material.

Last year the Ukrainian market of a metal tile was about six million square meters. There are eleven manufacturers in Ukraine and the major companies are based in Kiev Dnipropetrovsk and the five largest companies account for 85-90% of the market. Since 2004, sales of metal tile and shaped boarding has increased in Ukraine by 15-20%. This surge is mostly the result of increased building activity through out the country, increased purchasing power in the general population which is interested in private housing construction, and high consumer confidence in Ukrainian manufacturers of metal tile. Since last year, also the price of metal tiling has risen up to 20% and continued growth in Ukrainian demand is expected. Ukraine's industrial construction is even more interested in the use of metal tiling than the private consumers. The market for metal tiling is likely to develop rather dynamically primarily because it is connected to development of private construction in Ukraine. Under

conditions of sufficient investment, the trend will go from large cities to the remote areas where there is the possibility of sizeable market potential. (Ukraine Trade Invest, 2006)

Only one in every thousandth roof is covered with ceramic tiling-and these are mostly architectural monuments. Because of the higher price of the ceramic tiling is usually considered too expensive for the buyers of metal tiling. However, due to the popular interest in metal roofing and increasing awareness of newer materials in the average price group, elite clients are beginning to consider ceramic tiling. The Ukrainian ceramic tiling market is serviced mainly by import producers although Ukrainian ceramic tiling is about 20% cheaper than the imports. The growth in demand is only with imported tiling due to years of domestic tiling manufacturing being of such poor quality. (Ukraine Trade Invest, 2006)

Previous research

International construction is broadly defined as an activity where a company, resident in one country, performs work in another country. It has traditionally implied companies from advanced economies carrying out work in newly industrialised NICs and/or in less developed countries (LDCs). (Ngowi et al. 2005, 137.)

Researchers such as Abdul-Aziz (1994) and Raftery et al (1998) have studied the factors that determine the entry of construction firms in the international market. Abdul-Aziz's (1994) research on global strategies of Japanese and American construction firms showed that the prime concern for multinational construction companies is long-term profitability. Instead of just evaluating the opportunities of the host country, they take integrative actions for long-term profitability, although the immediate costs would be high. However, it is not indicated in the research, why and how foreign investment is considered to increase long-term profitability. In a research by Raftery et al (1998) it was found that Japanese contractors are successful in Asia, and their success can be attributed to their technological superiority, their financial capacity, their skill in forming strategic alliances with host governments and local firms.

These multinationals are described to have their competitive advantage stemming from technology, management and finance. Most of these competitive advantages are expected to be based on home country environment and the intra-firm network. Although their researches explain, why some construction companies are competitive over others, they do not explain, why their internationalisation must take the form of foreign direct investment. The motives of foreign direct investment are explained only by the willingness of host country government to attract inward FDI. Thus the firm-specific reasons to undertake foreign investment are not examined.

Theoretical Premises

According to Makino et al. (2002) one of the key issues in the field of international business research is how firms exploit their existing competitive assets and explore new assets in host countries through FDI. They have stated that the asset-exploitation perspective of FDI assumes that firms invest overseas in order to seek markets or low-cost natural resources or labour force. In the asset-seeking perspective FDI is viewed, instead, as a means to acquire strategic assets (e.g. technology, marketing and management experience) available in a host country.

Most previous studies and theories on motives of foreign investment have examined only either side of the two motivation sources in explaining the location of FDI. More recent studies suggest that firms would engage in FDI not only to transfer their resources to a host country, but also to learn, or gain access to, the necessary strategic assets available in the host country (see e.g. Makino et al. 2002).

Hence, FDI can be interpreted as a process in which resources are committed to creating, building and acquiring competitive assets in foreign countries in order to establish and develop positions for the investing firm in relation to its counterparts in foreign networks. An FDI project can be thus viewed as a node in the network of the investing firm's global business. This node not only connects different business activities of the firm but also connects the firm's business network to the market networks of the country (Yang 2005).

Asset-Exploitation Motives of Foreign Investment

Asset-exploitation motives of foreign investment refer to the transfer of a firm's competitive assets across borders. Hymer (1976) suggested that such advantages included the abilities to acquire factors of production at a lower cost than other firms, the knowledge or control of more efficient production functions, better distribution facilities or differentiated products.

From another perspective, internalisation theory suggests that it is not merely the possession of the existing advantages, which makes companies successful in foreign markets, but their ability to internalise that asset rather than selling it. Involvement in foreign markets is therefore determined by certain firm-specific advantages, which can be exploited in the host country and which are not shared with local companies through exporting or licensing. (Makino et al. 2002.)

Eclectic (OLI) Paradigm as a Determinant of Foreign Direct Investment

Dunning (1998) has criticised internalisation theory for ignoring the importance of locational factors and suggests that the critical choice of whether or not multi-activity firm should internalise its intermediate products is determined by the costs and benefits of adding value to these products in two locations. In its complete form, the eclectic (OLI) paradigm, developed by Dunning over the past decades, suggests, that the extent of MNC's foreign involvement consists of three sub-paradigms: ownership advantages (O), locational advantages (L) and firm's willingness to internalise (I) these advantages through foreign direct investment. (see e.g. Dunning 2000.)

The eclectic theory has not remained unchallenged. Firstly, the concept of firm-specific advantage is considered as a rather short run phenomenon, as it is only in the short run that ownership assets are fixed. It is a drastic oversimplification to expect a firm to undertake a long-term commitment in the form of FDI, in order to exploit short run advantage. In the long run, other firms may catch up with the foreign investor and erode their ownership advantages. Thus in the long run these firms must either generate new sources of competitive assets or to erect barriers to entry (e.g. by creating brand loyalty). (Singh 2001.)

Competitiveness of Companies

Both theoretical and empirical studies have indicated that the competitive advantage of a firm is strongly influenced by the business environment in which the company operates. Porter (1990) has offered a model which aims to capture the major determinants on competitive advantage. The four environmental characteristics that determine the success of an industry or group of industries in a particular location are:

- local factor conditions
- local demand conditions
- supporting and related industries
- firms' strategy, structure and rivalry

Furthermore, *government* and *chance* are two exogenous factors that in Porter's view influence the functioning of these four major determinants (Porter 1990).

Xu and Greenwood (2006, 441) have pointed out that it is not necessarily competitiveness of the home country that defines the success of a construction company in the host market, because the international competition takes place at local level. In the local level firms can gain competitive advantage, according to Porter (1990), by either low-cost strategy or differentiation strategy. As advanced economy MNCs may find it difficult to utilise low-cost strategy in the LDC markets, they must differentiate themselves from their competitors. This is possible by value-added services and brand names that the local competitors fail to provide. Furthermore Xu and Greenwood (2006, 441) have listed the key sources of competitive advantage for international contractors by which the differentiation strategy can be implemented: (1) provision of attractive financial packages, (2) building winning alliances, (3) accepting and managing risk, (4) investing in sales and R&D, (5) identification of customer needs through market research, (6) procurement on a global basis, (7) employment of technical expertise and right technology, (8) integration of local and global knowledge, and (9) political backing.

Asset-Seeking Motives of Foreign Investment

As stated above, the underlying assumption of the motives of foreign investments is that a firm must have some distinctive advantages to exploit when entering international markets. Recently, researchers have recognised that firms invest in foreign countries not only to exploit their firm-specific advantages but also to explore new strategic assets in a host country.

As FDI leads to the formation of international networks, which enable resource exchanges and information flows, FDI can be used not only to exploit firm's ownership advantages across the borders but also to obtain strategic resources and important information from the local environment (Yang 2005, 94). Over the past years, significance of different ownership specific advantages has also changed. As an outcome of the development, the integration of own and other firms' knowledge intensive assets have become increasingly important. (Dunning 2000, 169.)

From the perspective of knowledge-integration, the internationalisation theory views motives of FDI as being related to the accumulation of international experience and the consequent reduction in location-based disadvantages (Makino & Delios 1996). Local knowledge comprises information and know-how about the local economy, politics, culture, and business customs of a region: information on local demands and tastes; as well as information on how to access the local labour force, distribution channels, infrastructure, raw materials and other factors required for the business operations in a region. Since such general knowledge usually takes the forms of location-based intangible assets, its acquisition results from local operating experience. Local knowledge can be regarded as both location- and firm-specific in nature and thus it may not be readily acquired through the accumulation of experience of the hiring of local managers alone. Acquisition of local knowledge can occur by three distinct local knowledge acquisition channels (Makino & Delios 1996):

- by forming a joint venture with a local firm
- by transferring the foreign company's past host country experience
- by the accumulation of operational experience in the host country

Networks and strategic alliances as a Source of Competitiveness

Porter (1990) has suggested two strategies for penetrating foreign markets: (1) to select modest or emerging segments and (2) to follow home-based multinationals. In Xu and Greenwood's (2006) view in the context of construction industry this could be further extended to third type of strategy – that of collaboration with a local partner.

It has been noted by Abdul-Aziz (1994) and Raftery et al. (1998) that in the construction industry, as a result of construction projects becoming more complex, strategic alliances have become the basis for the business activities. The nature of the industry makes it difficult to undertake all tasks independently, and companies need to concentrate on their core competence to remain competitive.

Abdul-Aziz (1994) notes that localisation of foreign activities makes business sense for construction companies. Especially employment of local people reduces overheads. In addition, it has been found that companies that localise their activities are more flexible to market downturns than expatriate companies; they are able to fine-tune marketing and service delivery to match local context; and the localised foreign affiliates even manage to develop own competitive advantages.

Similarly, Xu and Greenwood (2006) have suggested that via collaboration-based entry (i.e. wholly-owned affiliate with local strategic alliances, project based collaboration, joint ventures or mergers and acquisitions) foreign contractors may reduce or overcome the difficulties that they encounter in the host market. Such collaborations facilitate to foreign company's adaptation to institutional issues, entry barriers, local culture, and may provide complementary competitive assets through utilisation of the partner's resources and local technical support, which other types of partnership might fail to offer.

Case Company operations in Ukraine⁶⁸

Ruukki Construction is a part of Finnish Rautaruukki Group. The company is divided into three different business areas. The most traditional, or at least the one usually associated with Rautaruukki is metal business, which still is the largest business. Rautaruukki also has two other business or customer divisions: Ruukki engineering and Ruukki construction which is the in the focus of this study.

Ruukki Corporation has a strict geographical focus covering Scandinavia, Central Eastern Europe stretching from Poland to Romania and Eastern Europe, including Ukraine and Russia. In Western Europe the company concentrates on certain key customers. Ruukki as a whole has a turnover of approximately 3.7 billion and the company employs 12,000 people.

Ruukki Construction is even more focused on the Central Eastern Europe than the whole Ruukki group. Eastern Europe is important since it generates growth for the company and Scandinavia is the basic area with established business. Ruukki Construction is further divided into three different geographical units. Eastern Europe includes Ukraine, Russia and Kazakhstan. Ukraine is one of the focus areas of the company and therefore they also have production in the country.

Ruukki Construction is one of the approximately 50 Finnish companies operating in Ukraine (Oliinyk, 2006). The company has local construction production in Ukraine although they also import goods from other countries to Ukraine. They have three production lines producing construction products in the country: two in Kiev region and one in Dnipropetrovsk located east from Kiev. These production lines are greenfield investments in the sense that the company has founded its own subsidiary in the country. The production lines are operating in rented facilities. Rautaruukki Corporation also completed the acquisition of AZST-Kolor CJSC, which owns a colour coating production line in Antratsit, in eastern Ukraine which was consolidated in Rautaruukki's reporting from June 2006. The unit produces raw material for the construction activities.

⁶⁸ The data for this section is based on two interviews with the vice president and the leader of the Eastern Europe unit of Ruukki Construction, Ari Vouti, as well as Ruukki corporation website and official documents, unless otherwise cited.

The market was entered in the end of 1990s and business has been developed and increased gradually. Existing contacts and networks in other countries were used in the process of entering these countries. The activities have started from the production and sales of steel roofs, which is extremely local. Simultaneously, the market has grown substantially and steel roofs were also a new way of constructing in Ukraine. Traditionally, the roofs have been made of bricks.

The construction production lines in Kiev and Dnipropetrovsk are producing construction materials such as steel roof products solely for the Ukrainian market. Antrasit, on the other hand is a raw material production unit. In the beginning it will serve the Ukrainian market, but in future it has been planned to produce material to be exported to Russia and other markets in Eastern Europe such as Romania, Hungary and Poland. Compared with the whole business area and the total sales of the group, the figures of Ukraine are not remarkable. Ukraine is, however, clearly the focus area of the company and it also aims to grow the business in the future.

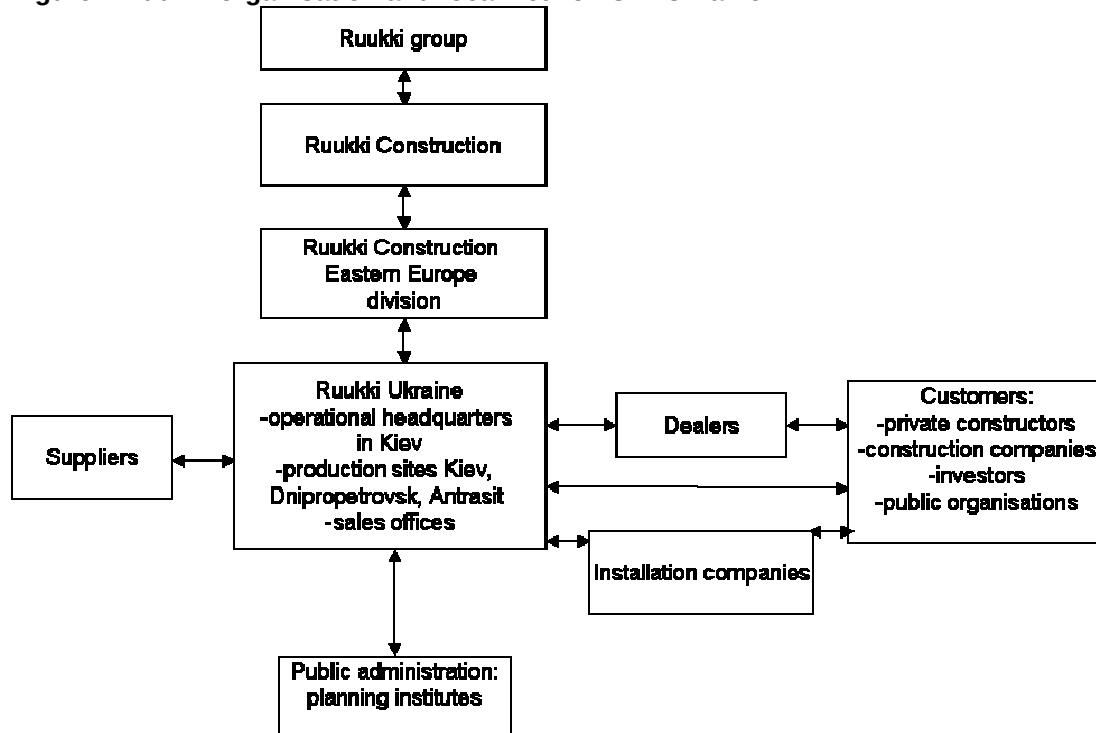
As for the market position in Ukraine, Ruukki is the leading manufacturer of steel roofing sheets, in other words they have the largest share of the market. Also in terms of panel sales, they are also fast attaining the largest market share. Also in terms of low profiles, which can be used in facades and roofs the company is among the three most important players. These are the products which are the basis for the good market position in the Ukrainian market. Considering competition in the construction sector of Ukraine, the market is not as crowded as in Russia for example. Currently the most important competition comes from the local actors. There are a couple of foreign companies in the market, but mainly, the competition is local. The competition is however likely to increase in the future as more foreign companies understand the possibilities of the market. It is therefore important for the company to develop its competitive advantages in order not to lose its position in the future.

The majority of the customers are concentrated in the capital region, since construction is growing most rapidly in Kiev. The company is however operating in the whole country and the customers are also situated in different parts of the country. The customer base in Ukraine is distinctive in terms of need for a larger retailer or dealer network, compared with Finland for instance where private construction is more do-it-yourself – typed and customers by construction components from hardware stores and installs them themselves. A lot of retail activities in Ukraine are also very small scale, so called garage sales, which means that the distribution of products is much more complicated than in Finland. On the other hand, larger construction companies are not yet present in the market and they are also quite small, often comparable to installation companies.

Local organisation and networks in Ukraine

The operational headquarters of the Ukrainian operations are situated in Kiev and the administration and sales of the country are managed from there. One of the production sites is also situated close to Kiev, where the construction is growing very rapidly. Another production site of the construction products in Dnipropetrovsk is situated in the middle of the country. The newly acquired colour coating line with the people responsible for the management of the production in Antrasit on the other hand is situated in the eastern part of the country, where a lot of heavy production is situated. The company also has about a dozen branch offices handling the sales of the products in different parts of Ukraine to be able to serve the large population in the large area of the country. The sales offices employ people responsible for the sales and handling the documentation and orders in other the branch offices take care of the order process and the customer relationships. The company also has many partners and important networks in the country (see Figure 1).

Figure 1 Ruukki organisation and local networks in Ukraine



The contact networks and partnerships in Ukraine form a wide whole. One network of the company in Ukraine is formed by the customers. In the residential segment the customers are mostly private buyers who want to install steel roof their houses. The component sales are still relatively high in Ukraine, which means that basic products are sold in large numbers through dealers or retailers. The dealers also form a network of their own covering the whole market. In the commercial construction the company is supplying to construction companies and investors. The company has also formed networks with architects and planners as well as the public administration, since in Ukraine the public administration still has a very important role and different planning institutes have more influence than in Finland for instance. Suppliers and distributors also form one network.

The company also participates in the installation process of the products, although it does not have own installation operations. Ruukki sells the products installed to the customer and from the customer's perspective Ruukki handles the installation. The installation is outsourced to an installation company network to which the products are delivered and after that installed to the customer.

Motives for FDI in Ukraine and sources of competitiveness

Construction is growing in Ukraine and the growing demand for construction services is the primary reason for Ruukki to operate in the market. Retail chains are also entering the market as the consumption and demand are growing. This leads to increasing demand for a developed logistical system and makes the market very attractive for construction companies. Infrastructure and distribution in Ukraine create many challenges, but also many possibilities for construction industry. The infrastructure is still quite undeveloped and creates a possibility for Ruukki to provide the needed developments. It can be said that the situation increases the possibilities of Ruukki as the business is largely based on building infrastructure. The situation is also positive in compared with Western Europe, since there is more demand for new construction production in Ukraine, which is more suitable for Ruukki products.

According to the case company it is essentially important to have local operations in Ukraine. There are several reasons for engaging in FDI in this context. Construction is a local business and local knowledge of the markets and partners important for the business affect the profitability of the company. Since the market and circumstances in Ukraine differ from the home market of the company, they see many benefits in having a local presence with local connections. Local management and workforce also bring the company closer to the market and the customers and accelerate the decision making, since the local employees are familiar with the circumstances in the country.

Steel construction also enables many new possibilities and is very suitable for these types of markets. It shortens the time of construction, and at the same time the whole lead-time of the projects. It also decreases risks, because the predictability of the timetable increases. Many parts of the construction materials can be produced already in factory conditions instead of building everything on site. This enables the transportation and installation of many parts that have been produced elsewhere. Steel roofing was also a new way of constructing in Ukraine when the company entered the market. By entering the market with a comparatively new product with high demand the company was able to use its existing assets in a new market with less competition than in its traditional markets and develop a good market position. The company has been able to use its knowledge of production technologies superior to local ones and simultaneously take advantage of growing demand in the host country.

One of the sources of competitiveness of the company in Ukraine is the use of local workforce. According to the case company it is essentially important to have local workforce running the operations in Ukraine. There are several reasons for the company to consider the local workforce as an important asset in this context. Since the market and circumstances in Ukraine differ from the home market of the company, they see many benefits in using local workforce instead of expatriates. Local management and workforce bring the company closer to the market and the customer and accelerate the decision making, since the local employees know the circumstances in the country. Business practices in Ukraine also differ from western countries. Local knowledge of the markets and partners important for the business therefore affect the profitability of the company. Local employees can be especially beneficial in situation where local parties try to take advantage of a western company by asking for higher prices. According to the company, the local workforce helps them not to be deluded and be more successful in negotiations with customers and officials.

The local management and employee team have also been able to build a vast contact and partnership network of different actors important for the business. The network of local actors and partners is crucially important in order to ensure the successful distribution and installation of the products. Relationships with the public administration also have a very important role in this context, since they have a strong influence in the sector. Finding reliable partners and establishing long-term relationships with them is very important for the business.

Conclusion

This case study offers an insight into the FDI and sources of competitiveness in the context of internationalisation of a foreign company into the construction sector of Ukraine. The analysis is based on a single case study and the results should not be generalised, but can be further studied with larger material in different contexts.

In terms of the OLI paradigm the case company has been using its ownership advantages: knowledge and techniques superior to local producers in the host economy with growing demand for its products. The decision to internalise the operations in Ukraine has been affected by the need to be close to the market and acquire local knowledge. Thus the

company has not only exploited their existing competitive assets in the host market but also sought new sources of competitiveness.

Being able to introduce relatively new products with better quality compared with the local producers is an important source of competitiveness for the company. Acquiring local knowledge and adapting to local conditions have also proved to create competitive advantage. The knowledge of local conditions and practices has been enabled by local management of the operations and networks of local partners. Also relations with public authority are better handled with local staff. This makes it possible to win projects and decreases the cost level in some occasions. Local presence also enables company to be close to customers and the network of related companies. Especially, for Ruukki's business operations in production and sales of steel roofs, the local presence is important, when most important parts of the company network are local. Most of all in Ukraine the situation is emphasised with a customer base spread in a large area and relatively small individual operators.

The network helps the company to concentrate on its core competence, and thus improves its competitiveness. Whereas some operations are outsourced to local companies, they are still showed to customers as being part of Ruukki's activities, which may increase the brand awareness in the host market and thus increase long-term profitability.

The importance of local knowledge and networks in the local community are found to be crucial for the success of the company's FDI operation. The company possesses technical knowledge of products which are superior to the local counterparts, but in order to be able to use the asset the company has found it as important to have local managers and networks in order to gain success in the market. Especially, when more foreign companies are expected to enter the market in the future, Ruukki needs to develop its existing competitive advantages in order not to lose its position in the host market. The results of this case study thus suggest that FDI may increase the competitiveness of construction companies in the host market relative to companies that solely rely on their existing competitive assets by other modes of internationalisation.

The case study provides support for previous researches, as it shows that local linkages can be a profitable strategy for penetrating host markets. However, the results of this single case study cannot directly be generalised in other contexts, and more information is needed on how local presence improves competitiveness of a foreign company. However, in this study the sources of competitiveness found in the operation of the case company may be valuable also for other companies engaging in international construction activities, especially in similar industries and host markets. Local operations seem to create competitive advantage in international construction activities and FDI is therefore an attractive option to enter host markets as a foreign construction company. Recruitment of local employees and building and maintaining local networks and connections should also be considered carefully when establishing construction activities in foreign markets. Especially, in the Ukrainian market with relatively large area and small operators vast networks are needed in order to be capable of covering the whole market.

As the research findings show foreign companies may also be interested in exporting their goods from Ukraine. Thus, Ukraine could develop their construction industry so that foreign companies would operate their Eastern European business activities from Ukraine. This would require attractive investment environment for foreign companies, which could together with local companies develop the construction sector in Ukraine.

On the basis of the results of this study it appears to be important to conduct more studies on the recruitment of local management and employees, and their impact on the competitiveness of the foreign affiliate. The localisation process of foreign operations is therefore an interesting area for further research. More information is also needed, on how foreign investments affect the competitiveness of local companies in the market. In this

respect it could be shown how local companies should seek foreign partners in order to stay in business after the expected increase in foreign entrants of the Ukrainian construction sector.

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Section 5

Corporate governance trends in new EU Member States and Russia

Measuring quality of earnings response to corporate governance reforms in Russia

Sheraz Ahmed⁶⁹

Department of Finance and Statistics, HANKEN-Swedish School of Economics & Business Administration, Helsinki, Finland.

Abstract

This paper investigates the earnings management response to Russian Corporate Governance reforms during the year 2002 when corporate governance codes were introduced. We study the effect of these codes on the earnings management practices of Russian companies. The event-study analysis is done by employing cross-sectional Jones (1991) Model to detect the earnings management in both periods. Our null hypothesis of “No Earnings Management in event-period” is rejected; however, the analyses highlight a decline in the use of absolute discretionary accruals during the reform period. We also found that companies’ compliance with IAS/USGAAP is significantly affecting the discretionary powers of the managers of these companies. International accounting standards and USGAAP provide clear indication of no earnings management in the subsequent firm-year. Both cross-sectional and panel data models show positive (inflating) abnormal accruals in Ferrous Metal industry and negative (deflating) abnormal accruals in Telecom industry. Whereas, Oil & Gas and power industries are more transparent in disclosing earnings in terms of managerial discretionary powers of using firm’s earnings. We found significantly lower absolute earnings management in these industries that represents better shareholders’ rights. The results are robust in favour of obvious earnings management practices in Russia during 1998 to 2003. However, we do not neglect the positive impacts of reforms that have urged the management to use more transparent methods to disclose actual performance but full impact is yet to happen when high concentrated ownership and insider trading exists. More targeted and refined codes are needed to overcome the excessive discretionary power problem in Russia.

JEL Classification: G30, G34, G38

Keywords: Earnings management, Corporate Governance, Accruals, Cash flow.

⁶⁹ TEL: +358 94 313 3402, FAX: +358 94 313 3393. Email: sheraz.ahmed@hanken.fi.

Introduction

In recent history, Corporate Governance has become a hot topic in both research and business practice around the world. It was ignored as a matter of potential importance for the development of a nation's economy until the East Asian Financial crisis of 1997-98. It drew attention to the problems of capitalism, communism and their relationship to poor local corporate governance practices and financial and ethical business scandals in Russia especially. The research in corporate governance has utilized different approaches and disciplines to highlight the threefold purpose of efficient corporate governance i.e. to facilitate and stimulate the performance of firms by creating and maintaining the incentives to motivate insiders to maximize the firm's performance. Secondly; to limit insiders' abuse of power over corporate resources and finally; to provide the means for monitoring the behaviour of managers for accountability and giving protection to investors. OECD Principles of Corporate Governance 2004 has laid down a framework for the member countries to adapt with. These principles are intended to assist OECD and non-OECD countries in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance.

There has been a lot of debate recently on Russian economy being the largest and most dynamic of all transition economies. Puffer and McCarthy (2003) argue that the emergence of corporate governance in Russia can be seen as four stages of transition from communism to today's open-market economy. These stages are Commercialization, Privatisation, Nomenklatura and Statization. Russian businesses still operate under highly bureaucratic control, while effective state regulation is lacking. Economic development in Russia varies across the country with Moscow the most advanced and rest of the country less developed but significantly improving. Hence, there is notable variation in corporate governance practices in Russia (Black, 2001). The need for responsible corporate governance existed since the early 1990s when the country began its transition to a market economy but no firm infrastructure was created to support it. With the creation of publicly owned companies in the early stages of privatisation, the corporate governance was needed to balance the interests of shareholders against those of potentially opportunistic managers.

Massive privatisation by voucher auction in 90s however, couldn't revive centrally planned economy into a real dynamic and open market due to lack of proper measures to deal with self dealing by managers and controlling shareholders. Instead it accelerated the self dealing by selling the control of biggest firms to state-affiliates who used their money and energies only to corrupt the government and to block the process of positive reforming in the country so that their actions could not be checked. Controlling the Russian oligarchies from abstaining the rights of minority shareholders is necessary by developing better institutions of corporate governance.

Earnings management in a Russian perspective is an interesting area to explore where economy is still in its early stages of maturity. After the introduction of market economy during President Boris Yeltsin's period, the Russian economy has gone through various stages of transition. Initial measures were based on agency theory; however country's history of communism and central planning diverted the attention of the governments especially with the beginning of a transition stage in 1990's. The aspect of agency theory that the managers' personal objectives may dominate to the detriment of other shareholders seems to have prevailed in Russia. Especially where managers were majority or significant shareholders as well as those in which they were not. The country was ranked last in 2000 among 25 emerging countries on responsible corporate governance criteria (Karmin, 2000). The substantial progress made recently including code of corporate governance (2002) has significantly improved the corporate governance structure in Russia. These codes were issued by the Institute of directors in February 2002. The code is an advisory without binding force on domestic corporations. However, when offering stock to the public or issuing bonds, it is critical for Russian firms to comply with the code in order to achieve a certain level of rating from the stock market. President Putin has made many substantial improvements in

this area since he took the office in 1999. However, a recent mega scandal of Yukos oil again pasted many questions on the face of Russian economy about its transparency and rights of investors. Unauthenticated use of discretionary powers to manage earnings has not been dealt with full strength.

Stickney and Brown (1999) answer the question “what is quality of earnings?” in their book as “reported earnings represent a reasonably accurate measure of the economic value-added by a firm during a particular reporting period and economic value likely to add in future periods”. Hence assessing the reported earnings based on above assumption is called as evaluating earnings management as there are several managerial incentives to manipulate the earnings that leads to an inappropriate measurement of economic value-added. Loomis (1990) states in Fortune magazine that CEOs consider earnings management as a tool to ensure that their firms meet earnings expectations. Kasznik (1999) test the management activity to overcome the earnings forecast errors by increasing or decreasing the reported earnings to minimize the cost of forecast error. Cost includes legal exposure and loss of reputation. Then there is a cost associated with earnings management. Teoh et al. (1998b) shows firms that manage earnings prior to initial public equity offerings experience poor stock return performance in subsequent 3 years. However, the incentives for managers and investors usually stand high above the total cost of earnings management. There are different incentives like to influence market participants by inflating earnings before seasoned equity offerings so that the investor’s expectations about future performance could be improved. This phenomenon was evidenced by Dechow et al. (1996) and Teoh et al. (1998). Then there are contractual incentives for firms to manage earnings particularly in management buyouts as shown by Perry and Williams (1994), Dye (1988), Truman and Titman (1988) and Wu (1997).

This paper investigates the earnings management response to Russian Corporate reforms during the year 2002 when corporate governance codes were introduced. Initially the purpose of this study is three-fold as it first detects the earnings management in Russia secondly, it investigates the relationship between accounting standards compliance by Russian companies (IAS/USGAAP or RSA) and earnings management and finally it estimates the impact on four major industrial sectors of Russian economy for improvements in earnings measurement practices and disclosure. Financial statement data of 91 Russian listed companies is extracted from UBS Brunswick Warburg Company Guides. Accruals model of Jones (1991) used by Dechow et al. (1995), where nondiscretionary accruals are function of changes in revenues (adjusted for the change in receivables), gross property, plant and equipment and operating cash flows has been employed to detect the earnings management practices employed by Russian firms in both before and after the introduction of corporate reforms like corporate governance code in 2002. This modified version of Jones model exhibit more power to detect earnings management because it already assumes that changes in credit sales result from earnings management in the period where a systematic earnings management is expected. The reasoning behind this is that it is considered to be easy to manage earnings by exercising discretion over the recognition of revenues on credit sales than cash sales. The period for our analysis is initially set as six years starting from 1998 to 2003 where “estimation-period” (period without any proper reforms and guidelines for the companies about disclosing earnings statements) is from 1998 to the end of 2001 and “event-period” (The period after the introduction of major corporate reforms) starts from 2002 till 2003⁷⁰. We consider our event as the launch of code of corporate conduct in year 2002, so we hypothesize a clear improvement in disclosure and earnings statement in the annual reports of 2002 and subsequently in 2003.

As we proceed, section 2 describes the earning management and corporate governance aspect of Russian companies, section 3 highlights the data characteristics and research

⁷⁰ The financial statements for the year 2004 were not available at the time of analysis .All listed companies are bound to disclose annual statements by the end of September in following year at latest. Hence, we have data for the year 2003 only for 68 companies.

design, hypothesis development, and model specifications, and section 4 presents the results of the analysis and section 5 concludes the paper.

Corporate Governance and Earnings Management in Russia

Corporate governance in Russia has different aspects to study; the development of corporate governance in Russia can be seen from many points of view including the expropriation of minority shareholders' rights. Residual claims and legal disputes between shareholders and management are everyday events. Hence, the concept of corporate governance is currently understandable to many Russian people and commonly used by popular newspapers and business magazines without special explanatory notes (Iwasaki, 2005).

Corporate Governance

The emergence of corporate governance in Russia can be seen as four stages of transition from communism to today's open-market economy. These stages are Commercialization, Privatization, Nomenklatura and Statization. Russian businesses still operate under highly bureaucratic control, while effective state regulation is lacking. However, a sustainable economic development and goals are only achievable after a better quality of corporate governance. In a fast globalization, the future of the country and companies depend on Russians economy's ability to compete on the world market.

Corporate governance is in its initial stages of development in Russia. There has been a lot of debate recently on Russian economy being the largest and most dynamic of all transition economies. Economic development varies across the country with Moscow the most advanced and rest of the country less developed but significantly improving. Hence, there is notable variation in corporate governance practices in Russia (Black, 2001). The need for responsible corporate governance existed since the early 1990s when the country began its transition to a market economy but no firm infrastructure was created to support it. With the creation of publicly owned companies in the early stages of privatization, the corporate governance was needed to balance the interests of shareholders against those of potentially opportunistic managers. Puffer and McCarthy (2003) analyze the conditions that led many business people, investors and government officials to eventually begin focusing on corporate governance as a key to Russia's economic development. Corporate governance has become a central element in Russia's attempts to become a full participant in the global business community in the 21st century. Major corporate legislation and reforms during the last decade has improved the corporate structure a lot, it includes the law of privatization of state and municipal enterprises (1992), Joint stock company law was first introduced in 1996 and then revised and amended again in 2002, Securities market law came into force in 1997 and most recently OECD principles of corporate governance were revised in 2004, Russian economy takes a lot of influence from other OECD countries so these principles are taken as grant.

In Russia initial measures were based on agency theory, however country's history communism and central planning diverted the attention of the governments especially with the beginning of a transition stage in 1990's. The aspect of agency theory that the managers' personal objectives may dominate to the detriment of other shareholders seems to have prevailed in Russia. Especially where managers were majority or significant shareholders as well as those in which they were not. The country was ranked last in 2000 among 25 emerging countries on responsible corporate governance criteria (Karmin, 2000). A substantial progress in corporate governance was deemed essential to develop the potential of Russia and its markets for foreign investments and local enterprises. A prime indicator of the country's economic objectives was the goal, announced by Putin in 2001, of achieving Russia's membership in the World Trade Organization (WTO). Putin has continued his

efforts to strengthen the corporate structure and attract outside investors through proper policies and legislation. In result, the investors are seeing the signs of improvement and they have started enhancing production facilities. The dramatic increase in the energy prices in the world have also resulted in more revenues for the country. However, problem of concentrated ownership is still there. However, Substantial improvement in the economy has been prevailed as some managers with the supervision of the state started implementing the disclosure and transparency in the accounts. President Putin also replaced the CEOs of 38% of government based energy giants. Substantial improvement also includes 700,000 companies with shareholdings in 2002 that was only 15 in 1991, although a small number of them are being traded publicly. Most of the companies are small in sizes and majority of shares are with managers and sometimes employees. However, the emergence of corporate governance surely attracts investors who believe in the early developmental stage of Russia. Anglo-American model that is adopted by the highly developed economies also seems to be prevalent in Russia. Russia's proximity to European countries also leads to a stakeholders-oriented system.

The country could develop a distinctly Russian version of corporate governance shaped by its distinctive culture and institutions. The study of corporate governance in Russia is an active aspect of research. More than 500 books and articles have been published in the last 10 years only in Russia whereas international agencies and scholars have produced even more work. Several researchers have suggested governance structures for Russia as Buck (2003) gave options of market-based governance to a relational governance and also discussed about constraints on Russia's choice of corporate governance reforms and found it theoretically difficult to increase the low level of foreign direct investment (FDI) and manufacturing standards will have to rise to world levels for any potential improvement in overall situation.

Earnings Management

Earnings management in Russia is an interesting thing to investigate; managers are considered highly biased working towards the interest of their own as well as government. Russian notorious voucher privatization only helped oligarchs and affiliates to gain more powers and expropriation of minority rights continues. Serious agency problems seem still prevailing because firms were not owned by shareholders but by the state in communism and still the managers have their affiliation with political personalities rather shareholders. Moreover, the problem of nondisclosure and non-transparency made Russia one of the riskiest countries in the world for investment. However, the first steps were taken in revitalizing the market transparency and competition by President Gorbachev in his economic restructuring program (Perestroika) in 1985 and then the process intensified till the fall of USSR in 1991. Several significant laws were made during 1980's and 90's. Recently more substantial corporate governance code of conduct of 2002 required firms to disclose transparent information to the market. Then the law of joint stock companies came into effect in 2002 offering minority investors better protection from dilutive share issues, improved dividend rules and require increased corporate accountability.

The protection of rights of minor shareholders is an important feature to control. The contractual incentives for managers to inflate or deflate earnings have been seen in Russian companies. Large corporations in Russia have more outsider ownership and minority shareholders and they are more shareholders friendly and more compliant with corporate governance codes and laws and also spend more money on compliance efforts. However, mega scandal of YUKOS Oil Company strengthened the urge for big private firms to disclose as much as possible information to the outside world than ever before. The Yukos scandal highlighted the earnings management practices of large-scale private companies for tax evasion and Govt's inefficient policies to interfere or to stop expropriation.

The Russian stock market grew at the rate of 8.3% during 2004, clearly shows the potential of the market and increased confidence of the investors. Investors are getting more and more interested in Russian market, state is taking significant steps to attract outside investment as well as from inside the country. However, the average earnings of Russian firms were 6.6% that is almost half of the average earnings of all emerging markets. Here it lacks behind and shows a low profitability of Russian stocks in 2004. The absence of standard IAS and US GAAP accounting practices is creating it less secured for small shareholders, as companies may abuse the rights by disclosing manipulated financial statements. Russia has made attempts to have its companies convert to IAS rather than Russian standards of accounting (RSA). Russian Prime Minister Mikhail Kasyanov announced on July 25, 2002 that all Russian companies and banks must prepare their financial statements in accordance with IAS/USGAAP starting January 01, 2004.

This study is unique in its sense, as it not only tries to detect the improvement in malpractices of Russian companies to manage their earnings for particular reasons. The rights of small shareholders have not been acknowledged by majority of firms in the past. Russian economy provides a very useful platform for the research on corporate finance generally and earnings management specifically as the economy is emerging towards an open-market scenario, Russian background of communism clearly suggests managers' intentions to get private benefits by stealing the value of the companies they acquired. Black et al. (2003) noted that managers could also make money by increasing the company's value rather stealing but they chose the easier and rapid way to achieve personal targets. Obviously, running the companies honestly was the best long-run strategy but they preferred present benefits instead of future profits due to uncertainty and that current profit was easy to be tucked away overseas by those managers⁷¹. International monitoring authorities and investment companies also put more focus on the activities of these companies when more and more outside investors are coming in to invest. However, we still foresee a major portion of the companies managing earning for particular purposes.

Different industrial sectors in Russia have varying response to reforms as the corporate governance structure is varying. Generally, power and ferrous metal industries have more concentrated ownership structure than other industries, however, telecom and consumer goods sectors are more diversified in ownership.

Data and Methodology

The data included in this study contains financial statement and balance sheet figures of 91 Russian companies for period starting 1998 to 2003. The total number of listed companies varies in different times because the Russian stock exchange levies very strict laws for continuous listing and companies that are struggling to cope with the laws usually get delisted from the RTS. On the other hand, companies are struggling to meet the requirements of listing due to weak governance mainly and also voucher privatisation in early 90s where the shares of the big companies were given to insiders, managers and workers, hence creating a situation where they didn't have to pay anything to acquire the stake and workers then sold their shares to managers at a nominal price. In fact, managers showed a weak performance of companies in the initial stages of privatisation to devalue the companies' stocks. The ownership then concentrated into the hands of managers that were actually appointed by the state. However, we got a list of 91 companies that are relatively more stable and have financial statement data available for whole period. Accounting data is taken from Russian Equity Guides of Brunswick UBS Warburg Bank, which is a well-known international investment company with strong interest in Russia. It was the first investment company who measured corporate governance index in Russia in 1999. The time period of

⁷¹ A recent and well known example is of Yukos Oil. The financial statement of Yukos oil in 1996 showed revenue of \$8.60 per barrel, about \$4 per barrel less than it should have been. Mikhail Khodorkovski skimmed over 30 cents per dollar of revenue while stiffing his workers on wages, defaulting on tax payments, destroying the value of minority shareholders and not re-investing in Yukos' oil fields (Black et al. 2003)

our analysis is 6 years starting 1998 to 2003 – a period of rapid improvements in Russian corporate governance - However, there are only 41 companies that have their financial statements for all 6 years of analysis. The remaining 48 companies' data is not available for the whole estimation period.

Total time period includes two major legislation i.e. Corporate Governance Code (2002) and Law of joint stock companies came into force on January 01, 2002 that underlies the legal requirements for all JSCs in Russia, implemented to improve the performance of the companies and also guards the rights of minor shareholders in all JSCs. The first four years i.e. 1998 to the end of 2001 are called as “Estimation-period” and period after 2001 till the end of 2003 is called as “Event-period”. Figure (1) highlights the performance of 41 Russian companies in 6 years starting from 1998 till 2003. The reported financial figures for revenues, property, plant and equipment and total assets from UBS Brunswick Warburg’s “Russian Equity Guides” are taken for analysis purposes. Figure shows a trend of growth, the size (total assets) is growing from 1999 and that is mostly due to the fixed assets (PPE). The financial crisis of 1998 seems to have affected Russian economy and it lasted till the end of 1999 but afterwards we see a continuous growth pattern in revenues. The values are the averages of accounting figures of all 41 companies in each year. *Rev* means average revenues, *PPE* reflects the average fixed assets (property, plant and equipment) and *TA* shows the average total assets of each year.

Figure 1 The average financial figures/performance of Russian companies for the period 1998-2003⁷²

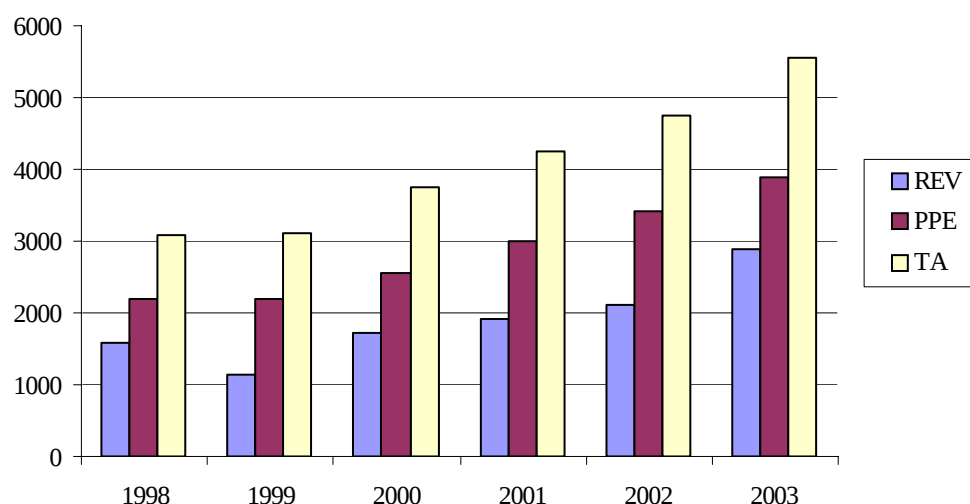


Table 1 shows the actual number of firm-years in the total period that has been used for analysis purpose as we need to calculate total accruals that reflects the change in certain financial variables e.g. current assets, current liabilities, operating cash flow, short-term debt and fixed assets. In this case the number of firm-years used in cross-sectional regression is 366 in both periods, consisting 207 in estimation-period and 159 in event-period. We have 155 firm-years from the companies complying IAS/USGAAP and 211 from the firm-years during which firms followed Russian Standard of Accounting (RSA) while disclosing their financial statements. Additionally, the distribution of observations as per industrial group is also presented in table (1).

⁷² “REV” is the average revenues, “PPE” means Property, plant and equipment and “TA” is Average Total Assets of those 41 companies only that have all 6 years of accounting statements available. We show the trend to generalize the results as different number of companies in each year may lead to asymmetric means.

Table 1 Distribution of Russian Companies according to Industry and Accounting Standards within the sample period 1998-2003 based on Total Accruals estimation

Industry	Years					Total
	1998-99	1999-00	2000-01	2001-02	2002-03	
Aerospace	0	2	3	3	2	10
Automobile	4	4	4	5	2	19
Consumer Goods	3	4	5	5	4	21
Engineering	0	1	1	2	2	6
Ferrous Metal	10	12	15	16	14	67
Fertilizer	0	2	2	2	2	8
Media & Technology	0	0	0	1	1	2
Non-ferrous Metal	1	1	3	3	3	11
Oil and Gas	12	13	14	14	9	62
Petrochemicals	0	0	0	1	1	2
Power	15	19	20	20	18	92
Retail	2	2	2	2	0	8
Telecom	5	6	13	13	6	43
Transport	2	2	3	4	4	15
Total	54	68	85	91	68	366
Accounting Standards						
IAS/USGAAP	23	28	34	39	31	155
RSA	31	40	51	52	37	211
Total	54	68	85	91	68	366

In order to convert data into a continuous series of variables and to avoid potential outliers, we divide all data points with their relative one period lagged total assets (Jones 1991). The whole time period is divided into two parts i.e. estimation period and event period. Table (2) shows the descriptive statistics of all variables in each period as well as whole sample period. The mean and standard deviation of each variable is a time-series mean of scaled values in each period. For instance, current assets scaled by one period lagged total assets has a mean of 0.373 and standard deviation of 0.192 in estimation period, whereas event period has a mean of 0.378 and standard deviation is 0.242, however, the mean and standard deviation in the whole sample period are 0.375 and 0.215 respectively. Table 3 shows a descriptive of all datasets used in analysis and presents a picture of data characteristics in each time period. Cash generated from operations (OPC/A_{t-1}) is less volatile in event period than estimation period. It shows a systematic reduction in operating activities during event period. There is trend of continuous increase in the production facilities (investing activities) among Russian companies, this trend continues from the year 1999 and so on.

Table 2 Descriptive statistics of financial variables used in regression analysis

The financial variables shown in the table are described as

CA/A_{t-1}	=	Current assets at year "t" divided by total assets of pervious year (t-1)					
CL/A_{t-1}	=	Current liabilities	"	"	"	"	"
OPC/A_{t-1}	=	Operating cash flows	"	"	"	"	"
D/A_{t-1}	=	Short term debt	"	"	"	"	"
Dep/A_{t-1}	=	Depreciation	"	"	"	"	"
Rev/A_{t-1}	=	Total Revenues	"	"	"	"	"
Rec/A_{t-1}	=	Short term receivables	"	"	"	"	"
PPE/A_{t-1}	=	Property, plant and equipment	"	"	"	"	"
$1/A_{t-1}$	=	One period lagged Total Assets	"	"	"	"	"

	<i>Estimation period</i>		<i>Event period</i>		<i>Total period</i>	
	<i>Mean</i>	<i>Std Dev</i>	<i>Mean</i>	<i>Std Dev</i>	<i>Mean</i>	<i>Std Dev</i>
CA/A_{t-1}	0.373	0.192	0.378	0.242	0.375	0.215
CL/A_{t-1}	0.304	0.184	0.279	0.192	0.293	0.188
OPC/A_{t-1}	0.088	0.140	0.090	0.123	0.089	0.133
D/A_{t-1}	0.074	0.091	0.103	0.126	0.087	0.109
Dep/A_{t-1}	0.049	0.036	0.056	0.035	0.052	0.036
Rev/A_{t-1}	0.860	0.511	0.963	0.501	0.905	0.509
Rec/A_{t-1}	0.158	0.103	0.159	0.107	0.159	0.105
PPE/A_{t-1}	0.683	0.294	0.718	0.277	0.698	0.287
$1/A_{t-1}$	0.004	0.009	0.004	0.006	0.004	0.008

Research Design

The methodology used in this study follows Dechow et al. (1995) modified version of Jones model of accruals. In the first phase of the study we apply model to detect the earnings management in Russia and test the power by Z-statistics used in above model. Earlier research has used accrual-based tests for earnings management however potential misspecifications and problem of a biased impact on results of the tests has been a major concern of those researchers. The accrual-based test of earnings management deals with Discretionary part of accruals in a linear model

$$DA_t = \alpha + \beta PRD_t + \sum_{k=1}^K \delta_k X_{kt} + \varepsilon_t \quad (1)$$

where

DA = discretionary accruals scaled by lagged total assets

PRD = dummy variable for periods dividing the data into two groups, according to the hypothesis⁷³.

X_k = other relevant variables that affect DA

ε = IID error term

It is highly unlikely that relevant variable (X) to be identified so we use the proxy for discretionary accruals as the original DA is not observable in absence of other relevant variables, DAP is then measured as the DA with error η as under

$$DAP_t = DA_t + \eta_t \quad (2)$$

Then the actual model be specified as

$$DAP_t = \alpha + \beta PRD_t + \theta_t + \varepsilon_t \quad (3)$$

⁷³ In a typical earnings management research, the partitioning variable "PRD" is set equal to 1 for all firm-years from the period where a systematic earnings management is hypothesized (Event-period) and 0 to all from the period during which no earnings management is hypothesized (Estimation-period).

Here θ is defined as the combined effect of the relevant variables unavailable to measure on the discretionary accruals. It also captures the error in estimation by using proxy. In case of omitted variable, the best possible regression model of proxy is presented below with a misspecified effect of portioning dummy variable. The “ b ” is then estimated as a closest and most reliable proxy of β in above model.

$$DAP_t = a + bPRD_t + \varepsilon_t \quad (4)$$

However, the above model of detecting earnings management has some biased properties and can lead to three statistical misspecifications in data analysis. First, the probability of type-I error increases when PRD is correlated with θ whereas the true parameter on PRD is zero (no earnings management in hypothesized period), this will increase the chances of estimated coefficient on PRD to be away from zero. Second, probability of type-II error when actual coefficient on PRD is non-zero but the correlation between PRD and omitted variables is in opposite direction of the true sign of PRD, the estimated coefficient will be biased away from zero. Third, the exclusion of relevant variable leads to an inflated standard error for the estimated coefficient on PRD when there is no actual correlation between PRD and relevant variables, in this case the estimate will not be biased but still has a probability of a type-II error.

Hypothesis Development

Event study analysis is carried on with our first Null hypothesis (h_1) of “*No Earnings Management in Event period*” and event is described as launch of corporate governance code in year 2002. Our estimation-period is from 1998 to the end of 2001 when the economy was suffering from a low level of corporate control due to lack of proper guidelines, our event-period (reform period) started with the introduction of an amended law of joint stock companies in the beginning of 2002 followed by major guidelines. We use companies’ actual accounting figures for year 2002 and 2003 to test the accrual-based earnings management model.

In order to minimize the problem of potential bias in Jones Model in absence of relative variables, we include two control variables; first one reflects the choice of accounting standards by a particular company and second considers the industry effect in estimation. These dummy variables can have an impact on the results and further elaborate the need for more exploration in earnings management research. Inclusion not only increases the confidence level of parameters but also explains the effects on managers’ intentions to accrue more in a particular industry and compliance with international accounting standards.

Model specifications

Consistent with the earlier studies by Healy (1985) and Jones (1991), total accruals (TA) scaled by lagged total assets (A_{t-1}) are calculated as

$$TA_t = (\Delta CA_t - \Delta CL_t - \Delta Cash_t + \Delta STD_t - Dep_t) / (A_{t-1}) \quad (5)$$

Here

ΔCA = change in current assets

ΔCL = change in current liabilities

$\Delta Cash$ = change in operating cash flow⁷⁴

ΔSTD = change in debt included in current liabilities

Dep_t = depreciation expense, and

A_{t-1} = One period lagged (t-1) Total Assets

Earnings before extraordinary items and discontinued operations is also standardized by lagged total assets, we know that cash from operations is,

⁷⁴ For some of the companies, the figure for operating cash flows in our data set is missing as it was not reported in UBS Brunswick Guides, we calculated the operating cash flows as “The sum of [net profit](#), [depreciation](#), change in accruals, and change in [accounts payable](#), minus change in [accounts receivable](#), minus change in inventories”.

$$OPCash = Earnings - TA \quad (6)$$

The nondiscretionary accruals proxy is estimated for event-period during which a systematic earnings management is not hypothesized due to the launch of corporate governance code in 2002 (stimulus)

$$NDAP_t = \alpha_1(1/A_{t-1}) + \alpha_2(\Delta REV_t) + \alpha_3(PPE_t) \quad (7)$$

Where

ΔREV_t = change in revenues scaled by lagged total assets

PPE_t = gross property, plant and equipment scaled by lagged total assets

However, according the modified Jones Model, the non-discretionary accruals proxy for estimation-period during which a systematic earnings management is hypothesized is calculated to eliminate the conjectured tendency of equation (7) when discretion is exercised over revenues. The original Jones model assumes that discretion is not exercised over revenues. This modification, if persistence, reduces the probability of occurrence of a type-I error described above; when discretion is exercised over credit sales that seems much easier for managers who inflate revenues without any actual cash flows. Hence, the estimated non-discretionary accruals in estimation-period is

$$NDAP_t = \alpha_1(1/A_{t-1}) + \alpha_2(\Delta REV_t - \Delta REC_t) + \alpha_3(PPE_t) \quad (8)$$

where

ΔREC_t = change in receivables scaled by lagged total assets

The estimates of firm-specific parameters α_1 , α_2 and α_3 are generated both for event-period and estimation-period using the following regression model.

$$TA_t = a_1(1/A_{t-1}) + a_2(\Delta REV_t) + a_3(PPE_t) + \epsilon_t \quad (9)$$

Then we estimate the discretionary accruals proxy (also scaled by lagged assets) by subtracting the predicted nondiscretionary accruals from total accruals calculated above:

$$DAP_{it} = TA_{it} - NDAP_{it} \quad (10)$$

In order to detect the earnings management and to test the hypothesis of no earnings management, we employ Dechow et al (1995) Z-statistics, we first divide our all observations into two parts i.e. event period and estimation period into two years each, then we estimate the t -statistics from the following ordinary model of linear regression.

$$DAP_{it} = \hat{\alpha}_i + \hat{\beta}_1 PRD_{it} + \epsilon_{it} \quad (11)$$

Here PRD (Dummy) is equal to 1 if the observation from event-period (during which no earnings management is hypothesized in response to reforms) and 1 if it is from estimation-period (earnings management due to absence of reforms).

Then we include more variables in above model (equation 11) to test the earnings management relative to the accounting standards (ASD), another dummy variable is included to test the effect of relative compliance with international accounting standards. The variable (ASD) takes the value of 1 if the particular firm-year is from the company that makes its accounts according to IAS or USGAAP and zero if it relies on Russian Standards of Accounting (RSA).

$$DAP_{it} = \hat{\alpha}_i + \hat{\beta}_1 PRD_{it} + \hat{\beta}_2 ASD_{it} + \epsilon_{it} \quad (12)$$

Third variable is related with the particular industrial sector (IND), to test the relative impact of each industrial sector in our analysis a variable takes the value of 1 if the observation is from a particular industry and zero for all others. Four major industrial sectors studied in the contest are i) Ferrous Metal, ii) Oil and Gas iii) Power and iv) Telecom. The model then will shape like

$$DAP_{it} = \hat{\alpha}_i + \hat{\beta}_1 PRD_{it} + \hat{\beta}_2 ASD_{it} + \hat{\beta}_3 \sum_{i=1}^4 IND_i + \epsilon_{it} \quad (13)$$

Where

IND_i = dummy used to identify the each of the four industries i.e. Ferrous Metal, Oil & Gas, Power and Telecom.

The coefficients $\hat{\beta}_1$, $\hat{\beta}_2$ and $\hat{\beta}_3$ provide relatively strong measure and also help to minimize the problem of un-identification of other relevant variables omitted from original equation (1). We try to provide even much better testing estimates of earnings management in presence of two other potentially relevant control variables that can cause rather much unbiased estimation. The industry effect and accounting practices effect has been a reason of differential earnings management in other parts of the world. Earlier research has evidenced the phenomena of a strong industry and accounting effect.

Hence our null hypothesis that $\beta_1 = 0$ can be tested by t -statistics and to detect the earnings management in all N companies involved in our analysis can also be tested by aggregating the individual t -statistics as under:

$$Z = \frac{1}{\sqrt{N}} \sum_{i=1}^N \frac{t_i}{\sqrt{k_i / (k_i - 2)}}, \quad (14)$$

where,

ki = degree of freedom for t - statistics

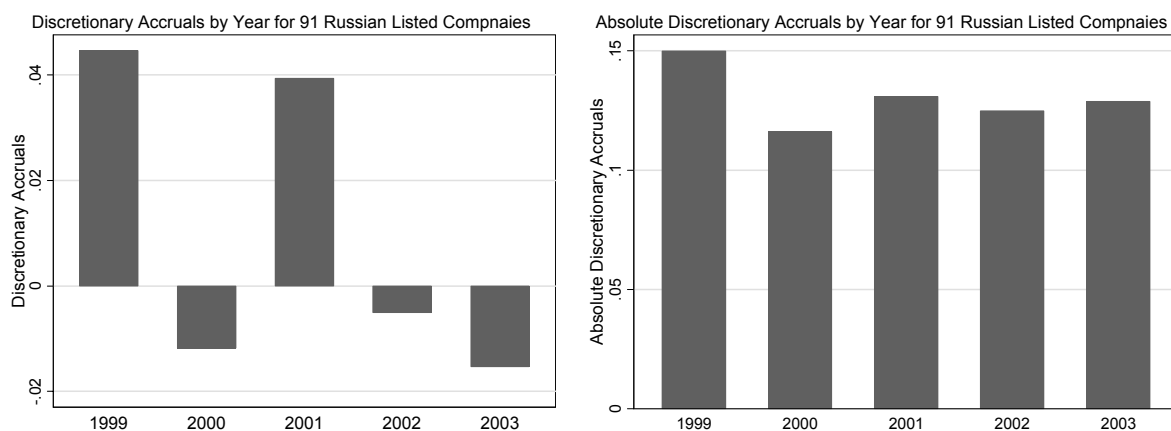
The Z-statistics is asymptotically unit normal if the t 's are cross-sectional independently distributed.

Results

The results shown in this section are robust and show a relatively accurate estimate of the models discussed in the previous section. The estimated parameters of equation (9) are first shown in table (3). We then measure the non-discretionary accruals using these estimated parameters to find out how the discretionary accruals shape up in the whole time period i.e. estimation period (before reforms) and event period (reform period).

The estimates shown in table (3) are obtained by linear regression of scaled total accruals with change in revenues and gross property, plant and equipment in the relevant firm-year. Remember we have total 366 firm-years and we made a cross-sectional time series analysis from which 207 are from estimation period and 159 from event period. Figure (2) shows discretionary and absolute discretionary accruals from year 1999 to 2003 of Russian companies, they are averages by the year and show negative accruals in year 2002 and 2003, however, in absolute terms there is no significant change in the values among years, which shows a systematic earnings management practices.

Figure 2 Discretionary and absolute discretionary accruals by Russian companies



The estimated parameters of our original model are now presented in table (4), the hypothesis of “no earnings management in event-period” in response to corporate reforms seems be rejected here, the (PRD) parameter represented by β_1 in all three models not equal to zero instead it is significant at conventional significance level of 5%. But the

negative sign of the parameter shows the direction of earnings management and is according to the prediction as we do not confirm no absolute earnings management after the reforms. The mean effect of the whole period (intercept) is positive and significant for first two models and positive but insignificant in model 3. This positive ness is due to the weight of the estimation period that has a positive relation with discretionary accruals. However, an insignificant intercept in case of model 3 elaborates the potential effect of an industry variable. Addition of other variables in a traditional earnings management models clearly increase the explanatory power of estimation. The mean effect of model 3 is much lower and insignificant due to inclusion of more potentially related variables like accounting standards and industry dummies. The problem of misspecification in original Jones Model (model 1) is addressed in model 2 and 3. The R-square-adjusted are 0.017, 0.019 and 0.058 respectively for each model that shows an increase in explanatory power of the models with inclusion of more variables. However, this does not offset the problem of misspecification completely. Last column of table (4) represents the results obtained by panel data analysis where only 66 firms were used in order to fulfil the requirement of minimum number of firm-years i.e. 4. Panel data analysis is done to check the robustness of original models. Further detail is provided in next section of the paper.

Table 3 Descriptive statistics of variable in regression and estimates in both estimation and event period as well as total period

The table presents the descriptive statistics and coefficients of regression analysis to measure the firm specific parameters for calculating non-discretionary and discretionary accruals proxy using equations (7), (8) and (10) respectively. Explanatory variables used in regression are i) $1/A_{t-1}$ = 1 divided by one-period lagged total assets, ii) change in revenues divided by one period lagged total assets ($\Delta REV/A_{t-1}$), iii) property, plant and equipment in year "t" divided by one-period lagged total assets. Estimation period is from 1998 to 2001 and event period (no earnings management is hypothesized) starts from 2002 to 2003. In first part of the table, the mean, standard deviation and correlation coefficients with dependant variable (Total Accruals) is shown, second part of the table shows the period specific parameters for both estimation period and event period. However, we use the parameters of total period to estimate the non-discretionary accruals proxy.

	<i>Estimation Period</i>			<i>Event Period</i>			<i>Total Period</i>		
	<i>Mean</i>	<i>Std Dev</i>	<i>Corr. With Y</i>	<i>Mean</i>	<i>Std Dev</i>	<i>Corr. With Y</i>	<i>Mean</i>	<i>Std Dev</i>	<i>Corr. With Y</i>
<i>Dependent Variable (Y)</i>									
<i>Total Accruals</i>	0.007	0.182	1.000	-0.036	0.206	1.000	-0.011	0.194	1.000
Explanatory Variables (X)									
$1/A_{t-1}$	0.004	0.009	0.089	0.004	0.006	0.326	0.004	0.008	0.174
$\Delta REV/A_{t-1}$	0.041	0.363	0.013	0.165	0.273	0.482	0.095	0.333	0.169
PPE/A_{t-1}	0.683	0.294	-0.103	0.718	0.277	-0.311	0.698	0.287	-0.201
Regression estimates									
				$TA_t = a_1(1/A_{t-1}) + a_2(\Delta REV_t) + a_3(PPE_t) + \epsilon_t$					
	<i>Mean</i>	<i>Std. error</i>	<i>z-stat</i>	<i>Mean</i>	<i>Std. error</i>	<i>z-stat</i>	<i>Mean</i>	<i>Std. error</i>	<i>z-stat</i>
$1/A_{t-1}$	2.420	1.450	1.669	7.147	2.212	3.232	5.372	1.228	4.375
$\Delta REV/A_{t-1}$	0.024	0.037	0.660	0.354	0.049	7.211	0.134	0.030	4.503
PPE/A_{t-1}	-0.017	0.020	-0.852	-0.173	0.020	-8.457	-0.079	0.015	-5.322

Table 4 Estimation of linear regression models using Discretionary accruals being exogenous variable

$$DAP_{i,t} = \hat{\alpha}_i + \hat{\beta}_1 PRD_{i,t} + \varepsilon_{i,t} \quad (\text{Model 1})$$

$$DAP_{i,t} = \hat{\alpha}_i + \hat{\beta}_1 PRD_{i,t} + \hat{\beta}_2 ASD_{i,t} + \varepsilon_{i,t} \quad (\text{Model 2})$$

$$DAP_{i,t} = \hat{\alpha}_i + \hat{\beta}_1 PRD_{i,t} + \hat{\beta}_2 ASD_{i,t} + \hat{\beta}_3 \sum_{i=1}^4 IND_{i,t} + \varepsilon_{i,t} \quad (\text{Model 3})$$

The value of PRD takes the value of 0 if the observation is from estimation-period during which a systematic earnings management is hypothesized and 1 if it is from event-period when no earnings management is hypothesized because of corporate reforms. Our hypothesis of “No earnings management in event-period” is tested by the value of β_1 , the value of ASD is 1 if the firm following IAS/USGAAP while making the accounting statements and zero if it adopts RSA. IND is a dummy for industry as it takes value 1 if the firm belongs to a particular industrial sector and zero otherwise in regression.

	Model 1	Model 2	Model 3	Model 4 (Panel data)
<i>Intercept</i>	0.031** (2.48)	0.042*** (2.79)	0.034 (1.47)	0.031 (1.25)
<i>PRD</i>	-0.052*** (-2.68)	-0.051*** (-2.65)	-0.052*** (-2.76)	-0.058*** (-2.78)
<i>ASD</i>		-0.025 (-1.30)	-0.001 (-0.05)	-0.023 (-1.00)
<i>IND-FM</i>			0.047* (1.64)	0.072** (2.23)
<i>IND-O&G</i>			-0.018 (-0.61)	0.01 (0.35)
<i>IND-PWR</i>			0.019 (0.72)	-0.02 (-0.65)
<i>IND-TEL</i>			-0.104*** (-3.20)	-0.065 (-1.62)
<i>No. of observations</i>	366	366	366	305
<i>R-squared</i>	0.017	0.019	0.058	0.075

* significant at 10% level

** significant at 5% level

*** significant at 1% level

The results are understandable and supporting the previous research on earnings management like Dechow et al (1995) and Jones (1991). The clear sign of improvements in Russia are obvious as the economy is struggling to cope with the international standards especially European Union expect much from the country in coming years. Its sheer size and neighbourhood attracts EU nations to have transparent corporate practices in Russia. Furthermore, the parameter for accounting standards β_2 negative but not significant (no use of discretionary accruals), this result is according to the international evidence of an inverse relationship between earnings management practices and compliance with international accounting standards, same is the case in Russia, where companies' compliance with IAS/USGAAP while making accounting statements is negatively related to the managers' discretion over firms' resources. Then the analysis of four major industrial sectors shows quite interesting and robust estimates of the relative parameters (β_3). Ferrous metal companies are generally involved in inflating earnings management practices as compared to telecom sector where managers significantly deflate earnings to possibly avoid high dividends to shareholders because the telecom companies usually have more dispersed ownership structure and Ferrous metal is one with concentrated ownership. Moreover, we do not find any statistical evidence of obvious earnings management in Power and Oil & Gas sectors due to better corporate governance structures. Oil & Gas companies including few more influential and biggest companies like Gazprom, Lukoil, Yukos etc use IAS and/or USGAAP hence, showing more transparency and better corporate governance structures. However, power sector is mostly controlled by regional governments that are ultimate

subsidiaries of state or affiliates and state owned companies have lower incentives of managing earnings, managers are appointed by state therefore they tend to concentrate more on gaining private incentives by enhancing their personal relationships with state than extracting company's sources.

Robustness of the results

In this section, we present some alternative tests to verify the results mentioned above. We performed panel data analysis using “Swamy (1970) Random Coefficient Model” with only 66 companies for which we have complete data for at least 4 years of analysis and we excluded all those companies with less than four years data in order to look whether there are any asymmetric biases in our original results. The total number of firm-years in this analysis was 305 and we performed the same steps while measuring the quality of earnings after reforms. The alternative methods showed same results and there are no significant variations in the pattern of accounting accruals before and after the reforms. Last column in table (4) above shows the regression estimates using panel data methods and support the results in other cross-sectional models used to test earnings management in standard way. However, it has slightly increased the explanatory power of the model showing greater power of exogenous variables in explaining the difference in discretionary accruals while addressing the firm-specific effects.

We also used residual approach to measure the discretionary accruals of the following model.

$$TA_{i,t} = \alpha_{1,i,t} (1/A_{t-1}) + \alpha_{2,i,t} \left(\frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{A_{t-1}} \right) + \alpha_{3,i,t} (PPE_{i,t}) + \varepsilon_{i,t} \quad (15)$$

Here residual ($\varepsilon_{i,t}$) is the same as discretionary accruals, the explanatory part of the above equation represents the non-discretionary accrual part out of total accruals and rest is discretionary part. This approach is widely used in earnings management literature. Our results are further strengthened by using this model and there are no differences in the overall outcomes but slight changes in coefficients. Table (5) represents the results obtained by residual model approach. Our period variable (*PRD*) is still significant and negative and only telecom sector shows very high negative (deflating) earnings management.

Table 5 Estimation of linear regression models using Residuals as proxy for Discretionary accruals

$$DAP_{i,t} = \hat{\alpha}_i + \hat{\beta}_1 PRD_{i,t} + \varepsilon_{i,t} \quad (\text{Model 1})$$

$$DAP_{i,t} = \hat{\alpha}_i + \hat{\beta}_1 PRD_{i,t} + \hat{\beta}_2 ASD_{i,t} + \varepsilon_{i,t} \quad (\text{Model 2})$$

$$DAP_{i,t} = \hat{\alpha}_i + \hat{\beta}_1 PRD_{i,t} + \hat{\beta}_2 ASD_{i,t} + \hat{\beta}_3 \sum_{i=1}^4 IND_{i,t} + \varepsilon_{i,t} \quad (\text{Model 3})$$

The value of PRD takes the value of 0 if the observation is from estimation-period during which a systematic earnings management is hypothesized and 1 if it is from event-period when no earnings management is hypothesized because of corporate reforms. Our hypothesis of “No earnings management in event-period” is tested by the value of β_1 . the value of ASD is 1 if the firm following IAS/USGAAP while making the accounting statements and zero if it adopts RSA. IND is a dummy for industry as it takes value 1 if the firm belongs to a particular industrial sector and zero otherwise in regression.

	Model 1	Model 2	Model 3
<i>Intercept</i>	0.029*** (2.30)	0.039*** (2.58)	0.031 (1.32)
<i>PRD</i>	-0.047*** (-2.42)	-0.046*** (-2.39)	-0.048*** (-2.50)
<i>ASD</i>		-0.023 (-1.20)	-0.000 (-0.04)
<i>IND-FM</i>			0.052* (1.78)
<i>IND-O&G</i>			-0.017 (-0.60)
<i>IND-PWR</i>			0.018 (0.66)
<i>IND-TEL</i>			-0.105*** (-3.19)
<i>No. of observations</i>	366	366	366
<i>R-squared</i>	0.016	0.020	0.071

* significant at 10% level

** significant at 5% level

*** significant at 1% level

Finally we detect the absolute earnings management while considering the absolute values of discretionary accruals calculated as residuals in above equation. This analysis helps us in identifying the difference in mean between two periods as well as among major industrial groups. Table (6) shows the results of both cross-sectional and panel data models discussed above. The intercept term becomes highly significant leaving coefficient identifying the period dummy as insignificant that shows no statistical difference in abnormal accruals during two periods. Hence, there is no significant change in the magnitude of earnings management in both periods, further strengthening the alternative hypothesis of no change in earnings management by the introduction of corporate governance codes in year 2002. Moreover, two industrial groups i.e. Oil and Gas and Power have shown significant amount of reduction in absolute mean values of abnormal discretionary accruals in all firms the difference in mean for Ferrous metal and Telecom is statistically zero meaning no difference from average of earnings management. The last column in Table (6) represents the results from Panel data model

Table 6 Estimation of linear regression models using Absolute Residuals as proxy for Discretionary accruals.

$$ADAP_{i,t} = \hat{\alpha}_i + \hat{\beta}_i PRD_{i,t} + \varepsilon_{i,t} \quad (\text{Model 1})$$

$$ADAP_{i,t} = \hat{\alpha}_i + \hat{\beta}_1 PRD_{i,t} + \hat{\beta}_2 ASD_{i,t} + \varepsilon_{i,t} \quad (\text{Model 2})$$

$$ADAP_{i,t} = \hat{\alpha}_i + \hat{\beta}_1 PRD_{i,t} + \hat{\beta}_2 ASD_{i,t} + \hat{\beta}_3 \sum_{i=1}^4 IND_{i,t} + \varepsilon_{i,t} \quad (\text{Model 3})$$

The value of PRD takes the value of 0 if the observation is from estimation-period during which a systematic earnings management is hypothesized and 1 if it is from event-period when no earnings management is hypothesized because of corporate reforms. Our hypothesis of “No earnings management in event-period” is tested by the value of β_1 , the value of ASD is 1 if the firm follows IAS/USGAAP while making the accounting statements and zero if it adopts RSA. IND is a dummy for industry as it takes value 1 if the firm belongs to a particular industrial sector and zero otherwise in regression.

	Model 1	Model 2	Model 3	Model 4 (Panel data)
<i>Intercept</i>	0.133*** (13.34)	0.155*** (13.32)	0.190*** (10.57)	0.188*** (10.53)
<i>PRD</i>	-0.008 (-0.58)	-0.006 (-0.49)	-0.009 (-0.68)	-0.016 (-1.10)
<i>ASD</i>		-0.052*** (-3.32)	-0.060*** (-3.67)	-0.062*** (-3.75)
<i>IND-FM</i>			-0.023 (-0.99)	-0.009 (-0.41)
<i>IND-O&G</i>			-0.054** (-2.34)	-0.052*** (-2.49)
<i>IND-PWR</i>			-0.055** (-2.57)	-0.052*** (-2.32)
<i>IND-TEL</i>			-0.028 (-1.09)	0.000 (0.005)
<i>No. of observations</i>	366	366	366	305
<i>R - squared</i>	0.010	0.040	0.069	0.078

* significant at 10% level

** significant at 5% level *** significant at 1% level

Conclusions

Russian corporate reforms have done much in a positive way to the Russian corporate sector, the results are very encouraging and further enlighten the need of a more strict and general reforms in the country. The economy is growing with a rapid pace and now it is a right time to put more efforts by the state representatives to grab the confidence of small investors as well. A long history of communism and central control has damaged the reputation and even the more significant efforts done so far since the fall of USSR do not seem to be much effective. However, recent efforts by the Government are staging a slow change in the overall situation.

Deflating earnings management (negative accruals) after the reform period is also reflected in the lower stock price of listed companies in Russia. Companies face lower value and liquidity problems in the market. Tax avoidance provides incentives for managers and controlling shareholders to report lower earnings than actual. Better enforcement of corporate tax laws can reduce this problem, than increasing tax rates. Wide-spread use of discretionary accruals makes the reported earnings least important and insignificant in valuation of Russian listed companies. The corporate governance aspect of tax accounting and malpractices is more important when ownership is more concentrated and the quality of corporate governance is meagre.

More companies complying with international standards; more efficient results. Generally, the trend is positive, as there were very few companies in 2000 adopting IAS/USGAAP now rated to almost 45% of all listed companies in 2004. There is no particular preference for either IAS or US GAAP; most of oil companies use US GAAP while IAS is popular among state-owned companies in oil & gas and telecom sectors. However, much concentration is needed towards ferrous metal and telecom sectors where manipulations are still persistent. Ferrous metal companies owned by state oligarchs seem inflating earnings for certain purposes, most importantly to raise the tax advantages collected by the state, remember we talk about oligarchs who are directly or indirectly enjoy government's support. Telecom sector is one the highest growth sector during recent past, most of the telecom companies in Russia are widely owned by private investors and international companies, who want to avoid heavy corporate tax brackets and also cash dividends to shareholders, they are growing rapidly and need more resources first to setup network and facilities for future business.

Corporate governance influences the business culture, and this cannot emerge overnight. This is particularly relevant to Russia, since it only has several years to catch up with countries that have been travelling down the same road for centuries. Progress in corporate governance can be made through the pooled efforts of companies interested in increasing their effectiveness and in forming a civilized market, as well as of the business community and government agencies. The study leads to highlight the importance of more internal power to control cash flow, to seize the initiative in management strategies and to prevent state's involvement. Preclusion of highly concentrated ownership, managerial entrenchment and corporate clustering needs to be focussed in all corporate reforms in the country. Recent revision of OECD Principles of Corporate Governance and Guidelines of corporate governance for state-owned enterprises should impact further as future research in this area is needed after a reasonable time when all existing reforms along with newly introduced and future efforts will take into effect more broadly.

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Financial transparency in Nordic and Baltic regions

Yuan Ding

China-Europe International Business School, Shanghai, China

Ole-Kristian Hope

Rotman School of Management, University of Toronto

Hannu Schadewitz⁷⁵
Turku School of Economics

Abstract

The recent integration of new members into the European Union and the movement towards accounting harmonization (adoption of IAS/IFRS in Europe) raises the following important questions: (1) Does financial reporting transparency differ between Eastern European firms, specifically Baltic firms, and their Western European counterparts? (2) Is upgrading accounting regulations and capital market operation sufficient to narrow the gap between the financial reporting transparencies of the two groups? Our paper addresses these two significant questions, which are of relevance to both investors and regulators. Prior studies have shown cross-country differences in disclosures, influenced by institutional factors. Our sample provides a unique setting in which the firms are subject to very similar capital market regulations, as the Helsinki, Stockholm, Copenhagen, Tallinn, Riga and Vilnius Stock Exchanges are all run by the same company: OMX. The possible bias related to differences in the operation of capital markets is thus largely eliminated. We include all non-financial firms listed in three Eastern European (Baltic) markets and compare them to a size and industry matched sample of Finnish, Swedish, and Danish (Nordic) firms. Our results show that Eastern European companies disclose significantly less information than their Scandinavian counterparts, after controlling for firm-specific characteristics. These results hold using three different measures of transparency. The evidence is consistent with the notion that disclosure levels and accounting quality will continue to vary considerably across countries despite the ongoing process of accounting harmonization and capital market consolidation.

Keywords: Transparency, disclosure, international comparison, capital market, Europe

⁷⁵ Corresponding author. The authors would like to thank Henri Bergström, Monica Bergström, Melanie Bonnet, Serge Evraert, Randall K. Filer, Jan Hanousek, Asbjørn Hansen, Rita Ilsson, Mikus Janvars, Thomas Jeanjean, Satu-Päivi Kantola, Laima Kazlauskienė, Olli Laurila, Fred Lindahl, Pirjo Matikainen, Timo Rintanen, Janne Seppänen, Hervé Stolowy, Stéphane Trebucq, Markku Vieru, Virpi Virkkunen, Kalle Viks, Min Wu (the discussant) and session participants at the 29th Annual Congress of the European Accounting Association (EAA), Dublin, workshop participants at the University of Bordeaux IV (CRECCI), EIASM workshop on Financial Market Development in the Central and Eastern European Countries, Prague, 4th INFINITI Conference on International Finance, Dublin, International Conference on Accounting Standards, Xiamen, China, and The Future Competitiveness of the EU and its Eastern Neighbours Conference, Turku, Finland for their helpful comments and advice. Ding acknowledges the financial support of the CEIBS Research Foundation. Hope acknowledges the financial support of the Deloitte & Touche Professorship. The authors would like to thank Ville Laiho, Yixin Luo, Tommi Sjöblom, Egle Juodsnukyte and Antanas Brazaitis for their able research assistance. Thomson Financial is acknowledged for the market data. Part of the research was conducted when the first author was affiliated with HEC School of Management, Paris.

Introduction

The financial reporting transparency of publicly listed firms differs not only across countries, but also across firms within the same country. The causes of these differences are quite complex and related to both variations in firm-based characteristics and institutional context divergences at the country level (Alford et al., 1993; Bushman et al., 2004).

Many researchers have taken an interest in the firm-based characteristics that might predict a firm's disclosure level (Healy & Palepu, 2001). For example, Raffournier (1995) explains the voluntary disclosure level of Swiss firms by examining their size, share listing, profitability, ownership structure, use of external financing, size of auditing firm, internationality and industry type.

Other researchers, meanwhile, focus on country (market)-level differences in disclosure. Three reasons have been put forward to explain why a group of firms from a specific country (or capital market) have a significantly higher (or lower) level of transparency than a group of firms from another country or market: accounting regulation (Ding, Hope, Jeanjean, & Stolowy, 2006), the stock exchange requirements (Adhikari & Tondkar, 1992) and other complex institutional factors (legal, governance, financial, economic, and professional development) (e.g., Ball, 2001).

Accounting harmonization and capital market consolidation and regulation is constantly evolving around the world. In Europe, some of the more important events include the adoption of IAS/IFRS in 2005, the creation of Euronext⁷⁶ and its possible merger with New York Stock Exchange and Borsa Italiana, and the partial acquisition of London Stock Exchange by NASDAQ. Supporters of the changes argue that such measures will enhance financial reporting transparency at firm level. For example, EU regulations stipulate that IFRS *"should, wherever possible and provided that they ensure a high degree of transparency and comparability for financial reporting in the Community, be made obligatory for use by all publicly traded Community companies"* (European Union, 2002, Art. 7). Other benefits are increased market liquidity, and ultimately, a reduction in the cost of capital.

Our research question is developed as follows. Under the control of OMX, the three centralized (command) economy Baltic countries and three Nordic countries use basically the same trading and quotation mechanism for their capital market. They also now have quite similar regulations on accounting and corporate governance for listed firms. Anecdotal evidence suggests that the basic filing and disclosure requirements of Baltic Stock Exchanges are in fact somewhat more stringent than in Nordic Stock Exchanges. Based on the arguments of international accounting standard-setters and capital market regulators, we should expect no variation in firm-based disclosure and accounting quality among these countries after controlling for firm characteristics. However, in line with prior academic literature which highlights the significance of country characteristics in influencing disclosure, we find significant differences for both disclosure and accounting quality between these two blocks of countries.

Taking all non-financial companies listed in three Baltic markets (63 firms) and comparing them to a size and industry matched sample of Finnish, Swedish and Danish firms, our results show that Baltic companies disclose significantly less information and their capital markets do not reward transparent firms. The results of our study are consistent with the notion that disclosure levels and accounting quality will continue to vary considerably from

⁷⁶ Euronext N.V., a holding company incorporated under Dutch law that operates through local subsidiaries, was formed on September 22, 2000 when the exchanges of Amsterdam, Brussels and Paris merged. The Euronext group expanded at the beginning of 2002 with the acquisition of LIFFE (London International Financial Futures and Options Exchange) and the merger with the Portuguese exchange BVLP (Bolsa de Valores de Lisboa e Porto).

one country to another even after the ongoing process of accounting harmonization and capital market consolidation (see Ball, 2001).

Our paper will proceed as follows. Section two describes the recent stock market integration in the Nordic and Baltic countries. Section three presents our approach to financial reporting transparency. Sample and data collection are reported in section four. Section five reports the results obtained for the determinants of transparency. Section six concludes the paper.

Market and accounting integration in the Nordic and Baltic countries

In general, stock market integration should make securities transactions more efficient and provide large-scale benefits, with the majority of market participants better off due to the market integration process. There should be a better match between supply and demand for traded securities. It is important to understand the choices, strategies, and performances of stock exchanges in order to further increase their productivity. In a global productivity study of stock exchanges, Hasan et al. (2003) report that European exchanges have improved the most in terms of cost efficiency. They also report that investment in technology-related developments effectively influences this efficiency. On the other hand, different market demands can cause differences in reporting quality. For example, Ball and Shivakumar (2005) report that, despite substantially equivalent regulations on auditing, accounting standards and taxes, UK private company financial reporting was of lower quality than public company reporting (see also Burgstahler, Hail, & Leuz, 2005). In our study, the organization of the market microstructure is generally comparable, but reporting by firms may deviate due to variations in market demand and country characteristics.

Market integration

The improvements in market transaction efficiency have also been targeted in Northern Europe via market integration. OMX has played a central role in this development. Through its Exchanges division, OMX owns and operates the equity and derivatives exchanges in Copenhagen, Stockholm, Helsinki, Tallinn, Riga and Vilnius as well as the central securities depositories in Estonia and Latvia. This offers access to approximately 80 percent of the Nordic and Baltic Securities market (www.norex.com).

The country-specific stock exchanges and their respective relationships with OMX are as follows: Copenhagen (Denmark, OMX Exchange owned since 2005)⁷⁷, Stockholm (Sweden, OMX acquired in 1998), Helsinki (Finland, OMX merged with OMX in 2003), Tallinn (Estonia, OMX owned since 2003), Riga (Latvia, OMX owned since 2003) and Vilnius (Lithuania, OMX owned since 2004). Denmark, Sweden and Finland are three Nordic countries and Estonia, Latvia, and Lithuania are three Baltic countries. This integrated Nordic-Baltic securities market offers a unique setting to test the impact of the institutional context on financial reporting transparency and quality in the context of highly-standardized market microstructure. Prior literature has shown that market microstructure affects both price formation and price discovery (Madhavan, 2000). The advantage in the OMX context is that the market microstructure is very similar throughout all OMX-run markets. In other words, differences in price formation and corporate disclosures are likely to originate from sources other than market microstructure and its requirements. This conclusion is also supported by the fact that OMX exchanges have harmonized their trading rules and membership requirements, as well as the training and accreditation of brokers.

⁷⁷ Although we study the 2004 annual reports of Danish firms included in our sample, these annual reports were published in 2005, i.e. under OMX.

Accounting harmonization

Contrary to the fairly highly-harmonized rules for trading, the regulation and legislation of listed firms' business communication is country-specific in these six countries. In general, EU directives provide the overall framework within which local legislators and other officials operate. In 2004 (our sample year), IFRS reporting was required only by Tallinn Stock Exchange (more detailed discussion below), while the other five stock exchanges allowed a choice between local or IFRS standards. Our 2004 annual report data shows that 30 out of 63 Baltic firms reported under IFRS and one, a firm listed at OMX Vilnius, under US GAAP.

We will now describe in more detail the situation of accounting regulations and their development in the three Baltic countries. This portion of the text is based on our email correspondence with the local responsible person/s with professional awareness (such as the Chairman of the Accounting Standards Board) regarding accounting development in their particular country.

In Estonia (OMX Tallinn), since 1993 the overall strategy has been to align Estonian GAAP with IAS/IFRS. The Tallinn stock exchange has required IAS/IFRS since 1998 – legislation was passed in 2002. This legislation requires all listed non-financial companies to apply IFRS from the accounting year 2003, and all banks and insurance companies (listed or non-listed) to do the same as of 2005. The law states that Estonian GAAP was based on the standards, interpretations and guidelines promulgated by the IASC in London. The law of 2002 introduced nothing particularly new, apart from the IFRS material, requirements for streamlining electronically stored data, and some other, mainly technical, details.

In Lithuania (OMX Vilnius), national GAAP are based on IFRS. The director of the Lithuanian Accounting Institute informed us that there are no important differences between national GAAP and IFRS. Before 2005, listed firms were allowed to report under national GAAP or IFRS. From 2005, listed firms are required, along with the rest of the EU, to apply IFRS. National accounting standards (30 have been approved) are only for non-listed firms.

In Latvia (OMX Riga), national GAAP are also based on IFRS. Before 2005, listed firms were allowed to report under either national GAAP or IFRS. Since 2005, listed firms have been required to apply IFRS. A representative of Riga Stock Exchange expressed the view that although the reports published by listed companies comply with IFRS and local standards, the informative content (regarding supplementary information) is on many occasions not yet satisfactory, and is below the level of Nordic listed firms. It should be mentioned that although IFRS are mandatory from 2005, their enforcement is still in progress.

None of the Nordic matching firms reported their 2004 annual reports under IFRS. Our size-matched design excludes Nordic early IFRS adopters, since they are large firms (Vieru & Schadewitz, 2006). Furthermore, in the vast majority of cases, their annual reports were audited by Big 4 auditing firms. In Scandinavia, 50 firms were Big 4 audited (eight non-Big 4) and in Baltic countries 52 firms were Big 4 audited (eleven non-Big 4). Although cross-listing is allowed within OMX Exchanges, no Baltic firm is listed on another OMX Exchange, and none of the firms in our matching sample is listed on another OMX Exchange. Because foreign listing could be a relatively straightforward reason to use foreign accounting standards, we checked whether any of our sample firms are listed abroad. Of the Nordic firms, only one was listed elsewhere, at NASDAQ. This firm followed Danish GAAP in its reporting. Of the Baltic firms, three were listed on a foreign exchange (all OMX Tallinn firms).

Measuring financial transparency

We will measure the financial reporting transparency by evaluating the degree and amount of disclosures in firms' annual reports. Our research question is: Does the financial information provided in annual reports by the firms vary between Nordic and Baltic countries when determinants other than the country are controlled for?

The actual information disclosures are evaluated by a disclosure index. In order to ensure robustness in our disclosure measure, we base our analysis on three systems of disclosure measures used extensively in the literature: CIFAR (Center for International Financial Analysis & Research - CIFAR, 1991), DSCORE (Botosan, 1997) and the Standard & Poor's Transparency & Disclosure index (2002) (see Appendix 1). We base our scoring on these lists of disclosure items. This enables us to compare our results with those of prior studies. Furthermore, CIFAR coverage tends to be biased toward large industrialized firms, and industrialized countries with developed stock markets (Pope, 2003). In order to avoid that bias, our study uses all annual reports, except from bank and insurance sectors, for firms listed in OMX Baltic exchanges. Scoresheets are filled in based on the original annual reports for 2004 fiscal years. As our aim is to study the overall level and quality of disclosure in annual reports, we do not consider whether disclosure items are voluntary or mandatory. It should be borne in mind that our disclosure index lists based on CIFAR, DSCORE and Standard & Poor's covers some very different dimensions of disclosure. Roughly speaking, the CIFAR-based index mainly follows items that are specifically regulated: for example, the CIFAR-based index clearly codes more types of accounting policies than the S&P-based index (Bushee, 2004). Overall, the DSCORE and S&P-based indices follow items that reflect more voluntary types of disclosure. The DSCORE-based index reflects five categories of information identified by investors and financial analysts as relevant in their decision making.

We attribute the values 1, 0 or "exclude" to each disclosure item in the indices. The general principle of the evaluation is as follows:

- 1 = The information is provided, or alternatively the firm discloses that it is inappropriate (impossible or irrelevant) to provide that piece of information.
- 0 = The information is not provided (although it would be possible) or alternatively, the firm does not disclose that the item is inappropriate to the firm's reporting.
- Exclude = No information, but the disclosure is irrelevant and there is no need to disclose that it is inappropriate.

A few illustrations of the procedures followed provide an insight into the scoring system. For example, there is a "diluted EPS" item in the CIFAR index. We assume that there is no dilution effect and require the firm to disclose this fact. If the firm discloses that there is no dilution effect, it scores 1 point. We never exclude "diluted EPS". On the other hand, there are items that are inappropriate for a particular firm, and we do not require the firm to disclose information about such items (coded as "exclude"). One example of this is "Percentage of sales in products designed in the last five years": we exclude, for example, electricity firms, because their operations are not based on product design. In this and similar cases we do not require the reporting of generally known matters.

The three disclosure indices applied are presented in appendix 1, listing all items applied in a particular index. Because they are either out of date or irrelevant for our studied sample, the following items are removed from the CIFAR index:

- Funds Flow Statement
- Funds from Operations
- Funds Definition
- Quarterly / Interim Dividends
- Separation of Non-Equity Reserves and Retained Earnings

—Total Assets Can Be Derived

Two items are removed from the S&P index for the same reason (detailed in Appendix 1). No items are removed from the DSCORE index.

Sample, data collection and scoring

Our sample is limited by the size of the three Baltic capital markets. We use information disclosed in annual reports for fiscal year 2004 to score our disclosure indexes. The scoresheets were filled out by two independent research assistants using original annual reports, in order to minimize the influence of subjectivity and personal opinions. Reasons for scoring differences were analyzed and corrections were made when necessary.

The annual reports were obtained primarily via the OMX website. If not available via this website, then they were obtained via the website of the firm concerned. The disclosure index is scored for the year 2004. After exclusion of banks and insurance companies, we have 63 Baltic firms in 2004. We then created a size and industry matched sample from Finnish listed firms. Where the match with Finnish firms was inadequate, we selected a matching firm from the Stockholm or Copenhagen Stock Exchange (Matching sample for 2004: Helsinki 39, Stockholm 11, Copenhagen 8, in total 58).

Finnish listed firms provide most of our matching firms mainly because the transparency levels between Finland, Sweden and Denmark are about the same: country-specific CPI scores for these three Scandinavian countries are (on a ten point scale) Finland 9.6, Sweden 9.3 and Denmark 9.5; while the corresponding CPI figures for the Baltic countries are Estonia 6.4, Lithuania 4.8 and Latvia 4.2⁷⁸. This suggests that our three Scandinavian countries have very low levels of perceived corruption. The three Baltic countries belong to the second and third quartile of countries in the study (n=102) according to the CPI for 2005.

Another reason for our use of Finland as a primary source for the matching sample is that at firm-level, Finnish firms have performed equally well in WebrankingTM as their Swedish and Danish counterparts. Webranking focuses on financial information and investor relations in its evaluations of firms' web pages (<http://www.webranking.nu>). For example, in 2005 the highest-ranking firm in Finland and Sweden, Storaenso, scored 78.5, and the highest-ranking firm in Denmark, Danske Bank, scored 71. In addition, the 25th firms in Finland, Cargotec and Finnair both obtained scores of 52, in Sweden, Eniro and NCC both obtained scores of 58.5, and in Denmark, Bang & Olufsen obtained a score of 31.5.

The third reason for our use of Finland as a primary source for the matching sample is that culturally and historically, it is closer to the Baltic countries than the other Nordic countries (Schadewitz & Blevins, 2000).

Since Baltic stock exchanges include many more firms from the energy industry, four Nordic energy firms are used as a match for two or three Baltic energy firms simultaneously. This means we have 58 Nordic firms compared to 63 Baltic firms in the matching sample for 2004. After eliminating eight firms because of missing data or extreme values⁷⁹, 113 firms (Nordic 54, Baltic 59) are included in all our regressions, except the spread regression (Nordic n=53 due to one extreme spread, Baltic n=23 due to lack of spread data from Vilna).

Our disclosure analysis is based on one year (2004), since firms' disclosure policies appear to remain relatively constant over time (Botosan, 1997, p. 327).

⁷⁸ Source: http://www1.transparency.org/cpi/2005/cpi2005_infocus.html.

⁷⁹ Three returns not available, one extreme value for sales, one extreme value for market-to-book and three extreme volatilities.

Statistical results – determinants for transparency

Our descriptive results show that the Baltic companies disclose significantly less information than their Nordic counterparts. Overall, the mean disclosure score is always lower for Baltic firms than for their Nordic counterparts (Table 1, columns: CIFAR, DSCORE, and S&P). The Z test also supports this conclusion. Standard deviation is lower for CIFAR and DSCORE in Nordic countries, and for S&P in Baltic countries. In particular, the Baltic firms have significantly lower disclosure scores related to ownership structure and corporate governance issues (Table 1, column: S&P Ownership; column: S&P Governance).

Table 1 Descriptive statistics for disclosure indices

n=121		CIFAR	DSCORE	S&P	S&P	S&P	S&P
				Overall	Ownership	Finance	Governance
Nordic region	Mean	82.4 %	46.5 %	64.8 %	67.2 %	62.7 %	65.0 %
	Standard deviation	5.8%	6.9%	10.8%	14.3%	9.7%	20.1%
Baltic region	Mean	78.2 %	31.7 %	37.2 %	31.7 %	57.0 %	22.1 %
	Standard deviation	7.4%	11.1%	8.2%	10.8%	9.9%	10.8%
Z		5.441***	16.268***	19.386***	18.869***	4.525***	16.301***

Nordic region = Finland, Sweden and Denmark, Baltic region = Estonia, Lithuania, and Latvia, CIFAR = Center for International Financial Analysis & Research based Index, DSCORE = Disclosure Score based on Botosan (1997), S&P based index constructed by Standard & Poor's. The scores report the percentage of items that were scored and received a score for satisfactory disclosure (1 for satisfactory, 0 for unsatisfactory). The standard deviation is the standard deviation of the % score, or the standard deviation of the raw score. The scores cannot be compared across the rows because they contain different items, but can be compared within the columns. ***, **, * designates statistical significance at the 1%, 5%, 10% level.

One likely reason for the higher Nordic ownership and governance scores could be the new corporate governance recommendations (effective date July 1st 2004). These recommendations were jointly designed by Helsinki Stock Exchange, the Central Chamber of Commerce and the Confederation of Finnish Industry and Employers as an update to the 1997 recommendations. One of the stated reasons for the update was the increased importance of corporate governance and its adequate disclosure for listed firms. There was a similar kind of corporate governance recommendation development in Sweden and Denmark. It should be mentioned that during the research period, Estonia and Latvia had no corporate governance recommendations. This is acknowledged as a caveat when comparing S&P indices based on different countries.

The difference in standard deviations for various disclosure indices is also notable. Standard deviation for CIFAR and DSCORE is higher for the Baltic region than the Nordic region. This may well be due to the more mature market conditions for the Nordic firms, for S&P index standard deviation is higher for the Nordic region than the Baltic. S&P subindices reveal some of the reasons for this situation. The S&P Ownership and Governance subindices have lower standard deviations in the Baltic region. Both of these subindices also have a low disclosure score. These subindices chiefly reflect voluntary information disclosures or information that is typically monitored by investors in emerging markets. The S&P Finance subindex, meanwhile, focuses chiefly on items that are regulated. In other words, from the distribution results here, regulation appears to cause disclosure convergence between the Nordic and Baltic regions for the items scored with this subindex.

It is also useful to analyze how the disclosure indices correlate with each other (see Table 2 below). Overall (all-firms sample), correlations between the different indices are fairly low, varying from 0.502 to 0.722. This means that the three main indices applied in the study

capture somewhat different reporting dimensions. Separate analysis of disclosure indices for Nordic firms and Baltic firms respectively gives an additional insight. While all indices are more highly correlated with each other in the Baltic region (from 0.483 to 0.743), the overall correlations between the indices for Nordic firms are surprisingly low, varying from 0.190 to 0.552. Specifically, in the Nordic region DSCORE vs. S&P Overall, correlation is low between the S&P Ownership and S&P Governance subindices. Correlations between S&P Overall and DSCORE, S&P Ownership and DSCORE, and S&P Ownership and S&P Finance are insignificant. One interpretation for these correlation differences between Nordic and Baltic countries could well be that the nuances measured by disclosure indices are relatively scarce in Baltic reporting. In other words, there are no large-scale, sophisticated variations in the level of disclosure. Furthermore, voluntary, usually firm-specific, disclosure is on average more advanced in Nordic firms than Baltic firms. This conclusion is supported with the findings based on CIFAR, which tracks items that are usually mandatory. The differences between Nordic and Baltic CIFAR-based indices are not as great as for other indices.

Table 2 Correlation tables for dependent variables in transparency regressions

Both Nordic and Baltic regions (n=121)	S&P			S&P		S&P
	CIFAR	DSCORE	S&P	Ownership	Finance	Governance
CIFAR	1.000					
DSCORE	0.502***	1.000				
S&P	0.570***	0.722***	1.000			
S&P Ownership	0.463***	0.621***	0.910***	1.000		
S&P Finance	0.601***	0.606***	0.536***	0.294***	1.000	
S&P Governance	0.471***	0.627***	0.961***	0.842***	0.368***	1.000

Nordic region (n=58)	S&P			S&P		S&P
	CIFAR	DSCORE	S&P	Ownership	Finance	Governance
CIFAR	1.000					
DSCORE	0.294**	1.000				
S&P Overall	0.552***	0.190	1.000			
S&P Ownership	0.269**	-0.136	0.669***	1.000		
S&P Finance	0.499***	0.568***	0.429***	-0.169	1.000	
S&P Governance	0.433***	0.066	0.936***	0.551***	0.242*	1.000

Baltic region (n=63)	S&P			S&P		S&P
	CIFAR	DSCORE	S&P	Ownership	Finance	Governance
CIFAR	1.000					
DSCORE	0.483***	1.000				
S&P Overall	0.679***	0.743***	1.000			
S&P Ownership	0.544***	0.572***	0.817***	1.000		
S&P Finance	0.615***	0.597***	0.721***	0.448***	1.000	
S&P Governance	0.457***	0.577***	0.806***	0.530***	0.285**	1.000
Sig.	***<1%	**<5%	*<10%	For variables. see Table 1 above		

It should be borne in mind that five out of six exchanges accepted either local or IFRS reporting during the research period (year 2004), with only the Tallinn exchange requiring IAS/IFRS reporting. Our results are consistent with the idea that disclosure levels and accounting quality will continue to vary considerably from one country to another even after the ongoing process of accounting harmonization and capital market consolidation. This is in line with Ball & Shivakumar (2005) who hypothesized and found that, despite equivalent regulation, private company financial reporting was of lower quality due to different market demand, regulation notwithstanding.

In this study, since all firms included in our analysis are listed in the OMX market system, we controlled for the fact that disclosure differences may be caused by the trading and quotation requirements of their capital market. Our previous analysis also shows that the regulation on accounting and transparency is more or less comparable between Nordic and Baltic countries. To a certain extent, the Tallinn market has an even tougher regulation environment, since it has obliged listed firms to adopt IAS/IFRS since 2004. However, before concluding that the significant differences in transparency observed between Nordic and Baltic firms are mainly caused by institutional environment divergence among these countries, we have to control for the influence of firm-specific characteristics, through regression analysis of size and industry-matched samples.

Following the disclosure literature, we include the following eleven characteristics of the firm as control variables: size (Bujaki & Richardson, 1997; Watts & Zimmerman, 1978), leverage risk (Salamon & Dhaliwal, 1980), profitability and performance (Giner, 1997; Singhvi & Desai, 1971; Wallace & Naser, 1995), audit quality (Becker, Defond, Jambolvo, & Subramanyam, 1998), accounting standards (Ashbaugh, 2001; Ashbaugh & Pincus, 2001; Ashbaugh, Collins, & LaFond, 2004; European Union, 2002), equity offer (Healy & Palepu, 2001), share liquidity, ownership concentration, volatility, sales growth and market-to-book .

Here is the model of our regression explaining transparency (eq. 1):

$$\begin{aligned} \text{Transparency} = & \alpha_0 + \alpha_1 \text{Region} + \alpha_2 \text{Size} + \alpha_3 \text{Leverage} + \alpha_4 \text{Profitability} + \alpha_5 \text{Auditor} + \\ & \alpha_6 \text{Accounting} + \alpha_7 \text{Equityoffer} + \alpha_8 \text{Liquidity} + \alpha_9 \text{Ownership} + \alpha_{10} \text{Volatility} \\ & + \alpha_{11} \text{SalesGrowth} + \alpha_{12} \text{MarkettoBook} + \alpha_{13} \text{Region} * \text{Auditor} + \alpha_{14} \text{Region} * \text{Equityoffer} \end{aligned}$$

Transparency	CIFAR, DSCORE or S&P index.
Region	Dummy variable equal to one if the company is from Finland, Sweden or Denmark and zero otherwise.
Size	Logarithm of total assets in Euros.
Leverage	Ratio of total debt over total assets.
Profitability	ROE – sector's mean ROE.
Auditor	Dummy variable equal to one if the company is audited by a Big 4 firm and zero otherwise.
Accounting	Dummy variable equal to one if the company uses IAS/IFRS or US GAAP and zero otherwise.
Equityoffer	Dummy variable equal to one if the company arranged an equity offer.
Liquidity	Aggregate end-of-month trading volumes adjusted for capital changes divided by common shares outstanding at the beginning of the time window.
Ownership	Aggregate percentage of three largest shareholders at the end of the fiscal year either calculated by voting rights or number of shares held.
Volatility	Logarithmic standard deviation of share prices calculated from end-of-week share prices
Growth of sales	Growth of sales between fiscal year 2003 and fiscal year 2004
Market-to-book	Market capitalization divided by book value of total common equity

Descriptive statistics for the independent variables are reported in Table 3 below (all-firms sample, Nordic firms sample, and Baltic firms sample). Due to our size matching, the mean sizes for the Nordic firms sample and the Baltic firms sample are very similar: 18.9 vs. 17.8. Size, however, is significant in the regressions. The descriptive statistics also show that the leverage for the Nordic sample (0.51) is rather higher than leverage for the Baltic firms alone (0.37). We also observe that the profitability of the Nordic firms sample is higher than the Baltic firms sample. The Auditor variable indicates that the firms in both samples (Nordic and

Baltic) are mainly audited by Big 4 auditors (for more details on this, see the discussion in Section 2.2 above). In other words, potential differences in transparency should not be due to variations in auditing quality.

An equity offer is a very rare event for the sample firms, as the mean value for the equity offer dummy is only 0.07. Ownership is highly concentrated for Baltic firms, whose mean value for the Ownership variable is 75.0%, compared to the Nordic firms' 47.8%. Importantly, standard deviation of ownership is also lower for Baltic firms than the firms in the Nordic sample. Finally, it is important to note that IFRS are more frequently applied in the Baltic firms than their Nordic counterparts (as reflected in an increase in the Accounting dummy). Specifically, our 2004 annual report data shows that 30 out of 61 Baltic firms reported under IFRS, and one under US GAAP. None of the Nordic matching firms reported their original 2004 annual reports under IFRS.

Table 3 Descriptive statistics for independent variables

	Nordic and Baltic regions n=113		Nordic region n=54		Baltic region n=59	
Variable	Mean	Std. deviation	Mean	Std. deviation	Mean	Std. deviation
Region	0.480	0.502	1.000	0.000	0.000	0.000
Size	18.326	1.537	18.910	1.631	17.792	1.236
Leverage	0.440	0.196	0.515	0.166	0.372	0.199
Profitability	0.000	0.238	0.001	0.282	-0.002	0.193
Auditor	0.850	0.359	0.850	0.359	0.850	0.363
Accounting	0.270	0.444	0.000	0.000	0.510	0.504
Equityoffer	0.070	0.258	0.070	0.264	0.070	0.254
Liquidity	1.384	1.654	2.388	1.881	0.465	0.497
Ownership	61.982	25.690	47.760	24.639	74.999	18.947
Volatility	-0.684	1.316	-0.089	1.141	-1.229	1.234
SalesGrowth	0.117	0.270	0.143	0.325	0.093	0.205
Market to book	1.943	1.442	2.520	1.516	1.414	1.149

Region = Dummy variable equal to one if the company is from the Nordic region (Finland, Sweden or Denmark) and zero otherwise, Size = Logarithm of total assets in Euros, Leverage = Ratio of total debt over total assets, Profitability = ROE – sector's mean ROE, Auditor = Dummy variable equal to one if the company is Big 4-audited and zero otherwise, Accounting = Dummy variable equal to one if the company uses IAS/IFRS or US GAAP and zero otherwise, Equityoffer = Dummy variable equal to one if the company arranged an equity offer during the sample year 2004, Liquidity = Aggregate end-of-month trading volume over shares outstanding, Ownership = Aggregate percentage of three largest shareholders at the end of the fiscal year. Volatility = Logarithmic standard deviation of share prices calculated from end of week share prices, SalesGrowth = Growth of sales between fiscal year 2003 and fiscal year 2004, Market to book = Market capitalization divided by book value of total common equity.

***, **, * designates statistical significance at the 1%, 5%, 10% level.

Table 5 below presents the results concerning determinants of transparency between the Nordic and Baltic regions. Before interpreting the results obtained, it is important to analyze potential multicollinearity among the independent variables. Rawlings (1988, p. 277) suggests $VIF > 10$ as a guideline for serious collinearity. The tests show that all VIFs for the variables in our regressions are below that threshold value. However, collinearity diagnostics show that one dimension of the model has quite a high Condition index value, suggesting some sort of collinearity. The correlation table for independent variables is shown in Table 4.

Table 4 Correlation table for independent variables - all firms sample

Variable n=113	CIFAR	DSCORE	S&P	S&P Own.	S&P Fin.	S&P Gov.	Region	Size	Leverage	Profitability
Region	0.275***	0.608***	0.823***	0.815***	0.246***	0.815***	1.000			
Size	0.351***	0.424***	0.426***	0.330***	0.444***	0.359***	0.365***	1.000		
Leverage	0.177*	0.189**	0.326***	0.321***	0.152	0.301***	0.363***	0.005	1.000	
Profitability	0.144	0.165*	0.114	0.031	0.193**	0.111	0.007	0.274***	-0.230**	1.000
Auditor	0.206**	0.129	0.076	-0.015	0.182*	0.077	0.006	0.183*	0.199**	-0.049
Accounting	0.008	-0.310***	- 0.469***	- 0.462***	0.073	- 0.538***	- 0.575***	-0.057	-0.248***	0.055
Equityoffer	0.096	0.056	-0.006	-0.046	0.097	-0.018	0.012	0.097	-0.036	-0.076
Liquidity	0.284***	0.385***	0.552***	0.475***	0.280***	0.545***	0.584***	0.385***	0.231**	0.090
Ownership	- 0.362***	-0.367***	- 0.561***	- 0.518***	- 0.315***	- 0.527***	- 0.532***	-0.188**	-0.394***	-0.070
Volatility	0.201**	0.331***	0.313***	0.278***	0.252***	0.270***	0.435***	0.395***	0.125	0.425***
SalesGrowth	-0.016	-0.020	0.049	0.061	-0.045	0.063	0.094	0.020	0.014	0.299***
Market to book	0.300***	0.336***	0.420***	0.369***	0.137	0.443***	0.385***	0.055	0.297***	0.288***

Region = Dummy variable equal to one if the company is from the Nordic countries (Finland, Sweden or Denmark) and zero otherwise, Size = Logarithm of total assets in Euros, Leverage = Ratio of total debt over total assets, Profitability = ROE – sector's mean ROE, Auditor = Dummy variable equal to one if the company is Big 4-audited and zero otherwise, Accounting = Dummy variable equal to one if the company uses IAS/IFRS or US GAAP and zero otherwise, Equityoffer = Dummy variable equal to one if the company arranged an equity offer during the sample year 2004, Liquidity = Aggregate end-of-month trading volume over shares outstanding, Ownership = Aggregate percentage of three largest shareholders at the end of the fiscal year. Volatility = Logarithmic standard deviation of share prices calculated from end-of-week share prices, SalesGrowth = Growth of sales between fiscal year 2003 and fiscal year 2004, Market to book = Market capitalization divided by book value of total common equity.

***, **, * designates statistical significance at the 1%, 5%, 10% level.

Variable n=113	Auditor	Accounting	Equityoffer	Liquidity	Ownership	Volatility	SalesGrowth	Market- to-book
Region								
Size								
Leverage								
Profitability								
Auditor	1.000							
Accounting	0.141	1.000						
Equityoffer	0.116	-0.088	1.000					
Liquidity	0.011	-0.355***	0.031	1.000				
Ownership	-0.076	0.270***	0.017	- 0.547***	1.000			
Volatility	0.128	-0.140	-0.018	0.206**	-0.200**	1.000		
SalesGrowth	-0.066	-0.035	-0.075	0.167*	-0.095	0.181*	1.000	
Market to book	0.175*	-0.259***	0.000	0.246***	-0.385***	0.239**	0.247***	1.000

Region = Dummy variable equal to one if the company is from the Nordic countries (Finland, Sweden or Denmark) and zero otherwise, Size = Logarithm of total assets in Euros, Leverage = Ratio of total debt over total assets, Profitability = ROE – sector's mean ROE, Auditor = Dummy variable equal to one if the company is Big 4-audited and zero otherwise, Accounting = Dummy variable equal to one if the company uses IAS/IFRS or US GAAP and zero otherwise, Equityoffer = Dummy variable equal to

one if the company arranged an equity offer during the sample year 2004, Liquidity = Aggregate end-of-month trading volume over shares outstanding, Ownership = Aggregate percentage of three largest shareholders at the end of the fiscal year. Volatility = Logarithmic standard deviation of share prices calculated from end-of-week share prices, SalesGrowth = Growth of sales from fiscal year 2003 to fiscal year 2004, Market to book = Market capitalization divided by book value of total common equity. ***, **, * designates statistical significance at the 1%, 5%, 10% level.

Table 5 Regression results – Determinants of transparency in the Nordic and Baltic regions

n=113 Variable	CIFAR	DSCORE	S&P Overall	S&P		
				Ownership	Finance	Governance
Constant	0.569	0.003	0.057	0.040	0.227	-0.075
	6.083***	0.022	0.427	0.216	1.727*	-0.346
Region	0.016	0.173	0.251	0.451	0.020	0.336
	0.463	3.400***	5.148***	6.631***	0.417	4.273***
Size	0.012	0.016	0.018	0.016	0.020	0.017
	2.341**	2.114**	2.547**	1.594	2.817***	1.453
Leverage	0.021	-0.010	0.025	0.038	0.055	-0.018
	0.575	-0.187	0.468	0.511	1.042	-0.206
Profitability	0.006	0.070	0.087	0.035	0.064	0.163
	0.189	1.363	1.774*	0.512	1.321	2.054**
Auditor	0.011	0.055	0.025	0.034	0.015	0.034
	0.451	1.461	0.683	0.687	0.413	0.579
Accounting	0.034	-0.006	-0.010	-0.005	0.052	-0.069
	1.897*	-0.224	-0.386	-0.132	2.100**	-1.679*
Equityoffer	0.058	-0.006	-0.003	0.005	0.010	-0.015
	1.704*	-0.113	-0.052	0.071	2.07	-0.191
Liquidity	0.003	-0.002	0.000	-0.010	0.003	0.004
	0.592	-0.248	0.036	-1.009	0.486	0.366
Ownership	-0.001	0.000	-0.001	-0.001	-0.001	-0.001
	-1.867*	-0.375	-1.861*	-1.684*	-1.689*	-1.106
Volatility	0.000	-0.005	-0.020	-0.023	0.001	-0.041
	0.069	-0.510	-2.347**	-1.896*	0.073	-2.894***
SalesGrowth	-0.027	-0.052	-0.039	-0.009	-0.044	-0.057
	-1.106	-1.429	-1.124	-0.183	-1.293	-1.027
MarketToBook	0.011	0.009	0.010	0.009	0.000	0.020
	2.030**	1.098	1.303	0.829	-0.058	1.662*
Region× Auditor	-0.004	-0.061	-0.011	-0.122	-0.003	0.062
	-0.120	-1.185	-0.220	-1.788*	-0.055	0.783
Region× Equityoffer	-0.071	0.032	-0.038	-0.107	0.051	-0.080
	-1.470	0.447	-0.558	-1.116	0.747	-0.719
R ²	0.309	0.468	0.750	0.713	0.327	0.746
Adjusted R ²	0.210	0.392	0.715	0.672	0.230	0.709
F	3.131***	6.163***	21.051***	17.402***	3.395***	20.511***
Sig.	***<1%	**<5%	*<10%	For variables see Table 3 above and eq. 1 in the text.		

The results show that the three transparency measures are quite consistent. All regressions are significant and Adjusted R² varies from 21% to 71.5%. The coefficient of our test variable *Region dummy* is positive and highly significant in all regressions, except with CIFAR and S&P Finance, suggesting that Nordic firms are much more transparent than Baltic firms for most of the measures, after controlling for firm-specific characteristics. Examination of the applied indices will give additional understanding of this outcome (see appendix 1 for the applied index lists). When we base our scoring on the adjusted CIFAR index list, the focus is on rules and regulations regarding firms' annual financial statements. Contrary to CIFAR, in DSCORE and S&P the focus is more on voluntary investor communication, and the same is true of the S&P Finance subindex compared to two other S&P subindices, Ownership and

Governance. In other words, Region is not a significant explanatory variable for the S&P Finance variable, but it is significant for the two other S&P subindices (S&P Ownership and S&P Governance). The degree of market maturity and investor sophistication are likely reasons for this kind of outcome. Our results show clearly that items listed in DSCORE and S&P are disclosed more frequently in annual reports of Nordic than Baltic firms, but no such region difference exists among items listed in CIFAR. The significance of the region variable in this pooled regression model leads us to test whether separate regressions for Nordic and Baltic region would be appropriate. We applied the Chow test to see whether the model for the Nordic and Baltic regions is the same (Gujarati, 1995). F-values for the test were as follows: model with CIFAR, F: 3.521; model with DSCORE, F: 4.184; and model with S&P, F: 8.913. All these Fs are highly statistically significant and therefore strongly support separate regressions for the Nordic and Baltic region respectively. We also analyzed the existence of heteroskedasticity using the Breuch-Pagan test for all transparency and spread models. At the 1% significance level, none of the models were heteroskedastic, and the return models' plot figures did not indicate any kind of heteroskedasticity. In view of these results, no formal test for heteroskedasticity was performed.

Separate transparency regressions are reported in tables 6 and 7 below. The Accounting variable is excluded in the regression for Nordic firms, since none of our sample Nordic firms used either IAS/IFRS or US GAAP in 2004.

Table 6 Regression results – Determinants of transparency in the Nordic region

Nordic n=54 Variable	CIFAR	DSCORE	S&P Overall	S&P		
				Ownership	Finance	Governance
Constant	0.289	0.215	0.065	0.049	0.213	-0.050
	2.377**	1.350	0.251	0.136	1.071	-0.106
Size	0.026	0.016	0.031	0.041	0.022	0.032
	4.175***	1.930*	2.369**	2.236**	2.202**	1.317
Leverage	0.031	-0.077	-0.004	-0.016	-0.050	0.068
	0.625	-1.190	-0.040	-0.107	-0.616	0.353
Profitability	-0.024	-0.027	0.088	0.062	-0.040	0.257
	-0.707	-0.602	1.215	0.619	-0.726	1.962*
Auditor	0.001	-0.008	0.017	-0.076	0.014	0.093
	0.058	-0.293	0.395	-1.274	0.409	1.184
Equityoffer	-0.023	0.011	-0.044	-0.102	0.044	-0.086
	-0.890	0.332	-0.797	-1.331	1.028	-0.855
Liquidity	0.003	0.004	-0.002	-0.020	0.010	-0.002
	0.675	0.696	-0.188	-1.508	1.442	-0.104
Ownership	0.000	0.000	-0.001	-0.001	0.000	-0.001
	-0.540	-1.040	-0.860	-0.729	-0.880	-0.527
Volatility	-0.009	0.016	-0.033	-0.056	0.023	-0.073
	-1.014	1.395	-1.796*	-2.225**	1.632	-2.219**
SalesGrowth	0.008	-0.025	-0.012	0.019	-0.010	-0.034
	0.362	-0.839	-0.253	0.281	-0.269	-0.393
MarketToBook	0.010	0.006	0.007	0.002	0.000	0.015
	1.864*	0.753	0.558	0.124	0.023	0.679
R ²	0.476	0.356	0.278	0.228	0.457	0.271
Adjusted R ²	0.354	0.207	0.110	0.048	0.330	0.101
F	3.909***	2.381**	1.652	1.268	3.615***	1.595
Sig.	***<1%	**<5%	*<10%	For variables see Table 3 above and eq. 1 in the text.		

Table 7 Regression results – Determinants of transparency in the Baltic region

Baltic n=59 Variable	CIFAR	DSCORE	S&P Overall	S&P		
				Ownership	Finance	Governance
Constant	1.058	0.405	0.460	0.464	0.627	0.317
	7.533***	1.608	2.677**	1.878*	3.280***	1.405
Size	-0.010	-0.007	-0.002	-0.007	0.002	-0.002
	-1.191	-0.451	-0.157	-0.523	0.167	-0.116
Leverage	-0.038	-0.009	-0.011	-0.012	0.078	-0.112
	-0.807	-0.101	-0.184	-0.143	1.212	-1.479
Profitability	0.049	0.163	0.044	-0.052	0.156	0.014
	0.860	1.578	0.628	-0.511	1.994*	0.153
Auditor	0.008	0.063	0.012	0.014	0.009	0.018
	0.285	1.320	0.377	0.310	0.256	0.423
Accounting	0.040	0.006	0.005	0.021	0.063	-0.058
	2.184**	0.183	0.224	0.657	2.528**	-1.983*
Equityoffer	0.041	-0.026	-0.008	0.016	-0.005	-0.024
	1.233	-0.432	-0.205	0.275	-0.114	-0.450
Liquidity	-0.063	-0.075	-0.053	-0.030	-0.069	-0.050
	-3.512***	-2.339**	-2.389**	-0.958	-2.818***	-1.746*
Ownership	-0.001	0.000	-0.001	-0.001	-0.002	-0.001
	-2.908***	-0.427	-2.092**	-1.404	-2.703***	-1.065
Volatility	0.000	-0.021	-0.020	-0.017	-0.017	-0.024
	-0.041	-1.482	-2.043**	-1.256	-1.585	-1.883*
SalesGrowth	-0.111	-0.088	-0.085	-0.038	-0.138	-0.077
	-2.358**	-1.047	-1.481	-0.462	-2.161**	-1.024
MarketToBook	0.021	0.017	0.027	0.039	0.008	0.038
	2.395**	1.121	2.575**	2.559**	0.661	2.771***
R ²	0.478	0.273	0.359	0.232	0.453	0.363
Adjusted R ²	0.356	0.102	0.209	0.052	0.325	0.214
F	3.910***	1.601	2.391**	1.288	3.544***	2.433**
Sig.	***<1%	**<5%	*<10%	For variables. see Table 3 above and eq. 1 in the text.		

The only strong explanatory variable for transparency is firm size in the Nordic region. The size coefficient is generally positive and significant, confirming the findings in existing literature that larger firms disclose more information and insight than smaller firms.

On the Baltic side, concentrated ownership is negatively related to transparency when measured by the CIFAR and S&P Overall indices. This is a natural outcome, since owners with concentrated holdings can use sources other than annual reports to obtain information from a firm. The Baltic results show that Profitability is basically unrelated to transparency. On the other hand, liquidity is negatively related to transparency.

The most important point is to check whether transparency is different between Baltic firms using IAS/IFRS/US GAAP and Baltic firms using local GAAP. The results with the CIFAR index show that the use of international accounting standards is related to a higher disclosure score. This result is also statistically significant. The same occurs with the S&P Finance subindex. International accounting standards help firms to communicate their financial affairs better to the market. On the other hand, use of international accounting standards can in fact decrease the disclosure level for certain items. The S&P Governance subindex measuring corporate governance generated significantly lower disclosure scores for firms using

international accounting standards compared to firms with local GAAP reporting. This result may be due to the fact that firms are accustomed to using local GAAP, and could mean that in certain areas it will take time and practice for firms to adjust their disclosures to the new standards. Furthermore, academic literature recognizes situations where a higher degree of harmony could even be a bad thing (Deegan, 2001).

Conclusions

This study demonstrates that although Baltic countries have adopted the sophisticated capital market mechanisms of Nordic countries and required their listed firms to comply with comparable (if not tougher) disclosure obligations, the listed firms from these countries still have a significantly lower level of transparency in comparison to their counterparts from Nordic countries. Our results hold with three different transparency-measuring indexes widely used in accounting literature. Region, especially, is an important explanatory variable for indices focusing primarily on voluntary disclosures (indices based on DSCORE, S&P Overall, S&P Ownership, and S&P Governance). In contrast, region is not an important explanatory variable for indices focusing primarily on mandatory disclosures (indices based on CIFAR and S&P Finance). These findings remain robust to several firm-specific characteristics.

Our study brings some timely empirical evidence to the current debates on accounting harmonization and transparency enhancement all over the world. With the internationalization of capital investment activities and the recent waves of corporate failures in major economies, many voices have been raised in favor of upgrading accounting regulations and strengthening transparency. IAS/IFRS are presented as a miracle cure for business ills. Mainly for this reason, the European Union decided to impose IAS/IFRS for the consolidated accounts of all listed firms from 2005. However, few people have questioned the effectiveness of such a change in improving actual firm-level transparency. Our results suggest that some more profound changes in the institutional environment are needed before firm transparency can be significantly improved.

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Appendix 1

Items included in CIFAR Index

A: General information

Address/Telephone/Fax/Telex
Product Segment
Geographic Segment
Management Information
Subsidiaries Information
Future plans/Chairman or CEO's Statement
Number of Employees
Fiscal Year-End

B: Income Statement

Consolidated Income Statement
Cost of Goods Sold
Complete Income Statement
Sales
Selling, General and Administrative Expenses
Operating Income
Foreign Exchange Gains/Losses
Extraordinary Gains/Losses
Income Tax Expense
Minority Interest
Net Income Reported

C: Balance Sheet

Complete Balance Sheet
Current Assets Separated from Fixed Assets
Current Liability Separated from LT Liability
Owners' Equity Separated from Liability
Cash and Cash Equivalents
Accounts Receivable
Inventories
Current Assets
Fixed Assets on Asset Side
Goodwill and Other Intangibles
Shareholders' Equity Changes
Appropriation of Retained Earnings

D: Funds flow / Cash flow

Cash Flow Statement
Complete Cash/Fund Flow Statement

E: Accounting Policies

Accounting Standards
Financial Statements Cost Basis
50% Long-Term Investments
Starting Point for Funds Statement
Research & Development Costs
Pension Costs
Reasons for Extraordinary Items
Inventory Costing Method
20% Long-Term Investments
21-50% Long-Term Investments
Acquisition Method
Accounting for Goodwill
Deferred Taxes
Outside Manager of Pension Funds

Long-Term Financial Leases
 Foreign Currency Translation Method
 Foreign Currency Translation Gains / Losses
 Discretionary Reserves
 Minority Interest
 Contingent Liabilities

F: Stockholders' Information

Dividend per Share
 Earnings per Share
 Number of Shares Outstanding
 Multiple Shares
 Par Value
 Total Dividends
 Stock Split / Dividend / Rights Issues
 Stock Price
 Stock Exchange Listing
 Volume Traded
 Diluted Earnings Per Share
 Changes in Capital
 Different Div. for Multiple Classes of Shares
 EPS for Multiple Classes of Shares
 Significant Shareholders
 Composition of Shareholdings

G: Supplementary Information

Earnings per Share Numerator
 Earnings per Share Denominator
 Notes to Accounts
 Disclosure of Subsequent Events
 Remuneration of Directors and Officers
 Research & Development Costs
 Capital Expenditure
 List of Board Members and Their Affiliations
 Exports; Financial Summary

Removed from our scoring

Funds Flow Statement

Funds from Operations

Funds Definition⁸⁰

Quarterly / Interim Dividends⁸¹

Separation of Non-Equity Reserves and Retained Earnings

Total Assets Can Be Derived⁸²

⁸⁰ Nowadays firms prepare only a cash flow statement.

⁸¹ Nordic and Baltic firms pay dividends once a year.

⁸² The last two items are obviously outdated.

Items included in DSCORE

I. Background Information:

- i. Statement of corporate goals or objectives
- ii. Barriers to entry are discussed
- iii. Competitive environment
- iv. General description of the business
- v. Principal products
- vi. Principal markets

II. Ten- or Five-Year Summary of Historical Results:

- i. Return-on-assets or sufficient information to compute return-on-assets (i.e., net income, tax rate, interest expense and total assets)⁸³
- ii. Net profit margin or sufficient information to compute net profit margin (i.e., net income, tax rate, interest expense and sales)
- iii. Asset turnover or sufficient information to compute asset turnover (i.e., net income, tax rate, interest expense and sales)
- iv. Return-on-equity or sufficient information to compute return-on equity (i.e., net income and stockholders' equity)
- v. Summary of sales and net income for most recent eight quarters

III. Key Non-Financial Statistics:

- i. Number of employees
- ii. Average Compensation per employee
- iii. Order backlog
- iv. Percentage of sales in products designed in the last five years
- v. Market share
- vi. Units sold
- vii. Unit selling price
- viii. Growth in units sold

IV. Projected Information

- i. Forecasted market share
- ii. Cash flow forecast
- iii. Capital expenditures and/or R&D expenditure forecast
- iv. Profit forecast
- v. Sales forecast

V. Management Discussion and Analysis:

- i. Change in sales
- ii. Change in operating income
- iii. Change in cost of goods sold
- iv. Change in gross profit
- v. Change in selling and administrative expenses
- vi. Change in interest expense or interest income
- vii. Change in net income
- viii. Change in inventory
- ix. Change in accounts receivable
- x. Change in capital expenditures or R&D
- xi. Change in market share

No items were removed for our scoring.

⁸³ The Finnish Accounting Standards Board requires ROI. Hence we accept ROI.

Items included in Standard & Poor's Transparency & Disclosure index (S&P Overall)

Ownership Structure and Investor Relations (S&P Ownership)

Does the company in its annual accounts disclose:

- 1 number of issued and outstanding ordinary shares disclosed?
- 2 number of issued and outstanding other shares disclosed (preferred, non-voting)?
- 3 par value of each ordinary share disclosed?
- 4 par value of each other shares disclosed (preferred, non-voting)?
- 5 number of authorized but unissued & outstanding ordinary shares disclosed?
- 6 number of authorized but unissued & outstanding other shares disclosed?
- 7 par value of authorized but unissued & outstanding ordinary Shares disclosed?
- 8 par value of authorized but unissued & outstanding other shares disclosed?
- 9 top 1 shareholder?
- 10 top 3 shareholders?
- 11 top 5 shareholders?
- 12 top 10 shareholders?
- 13 description of share classes provided?
- 14 review of shareholders by type?
- 15 number and identity of shareholders holding more than 3%?
- 16 number and identity of shareholders holding more than 5%?
- 17 number and identity of shareholders holding more than 10%?
- 18 percentage of cross-ownership?
- 19 existence of a Corporate Governance Charter or Code of Best Practice?
- 20 Corporate Governance Charter / Code of Best Practice itself?
- 21 details about its Articles of Association. (e.g. changes)?
- 22 voting rights for each voting or non-voting share?
- 23 way that shareholders nominate directors to board?
- 24 way shareholders convene an EGM?
- 25 procedure for putting inquiry rights to the board?
- 26 procedure for putting proposals at shareholders meetings?
- 27 review of last shareholders meeting? (e.g. minutes)
- 28 calendar of important shareholders dates?

Financial Transparency & Information Disclosure (S&P Finance)

Does the company in its annual accounts disclose:

- 1 its accounting policy?
- 2 the accounting standards it uses for its accounts?
- 3 accounts according to the local accounting standards?
- 4 accounts according to an internationally recognized accounting standard (IAS/US GAAP)?
- 5 its balance sheet according to international accounting standard (IAS/US GAAP)?
- 6 its income statement according to international accounting standard (IAS/US GAAP)?
- 7 a basic earnings forecast of any kind?
- 8 a detailed earnings forecast?
- 9 financial information on a quarterly basis?
- 10 a segment analysis (broken down by business line)?
- 11 the name of its auditing firm?
- 12 a reproduction of the auditors' report?
- 13 how much it pays in audit fees to the auditor?
- 14 any non-audit fees paid to auditor?
- 15 consolidated financial statements (or only the parent/holding co)?
- 16 methods of asset valuation?
- 17 information on method of fixed assets depreciation?
- 18 a list of affiliates in which it holds a minority stake?
- 19 a reconciliation of its domestic accounting standards to IAS/US GAAP?
- 20 the ownership structure of affiliates?
- 21 details of the kind of business it is in?
- 22 details of the products or services produced/provided?
- 23 output in physical terms? (number of users etc.)

- 24 characteristics of assets employed?
- 25 efficiency indicators (ROA ROE etc.)
- 26 a discussion of corporate strategy?
- 27 any plans for investment in the coming year(s)?
- 28 detailed information about investment plans in the coming year(s)?
- 29 an output forecast of any kind?
- 30 an overview of trends in its industry?
- 31 its market share for any or all of its businesses?
- 32 a list/register of related party transactions?
- 33 a list/register of group transactions?

Board and Management Structure and Process (S&P Governance)

Does the company in its annual accounts disclose:

- 1 a list of board members (names)?
- 2 details about directors (other than name/title)?
- 3 details about current employment/position of directors provided?
- 4 details about previous employment/positions provided?
- 5 when each of the directors joined the board?
- 6 classification of directors as an executive or an outside director?
- 7 a named chairman listed?
- 8 detail about the chairman (other than name/title)?
- 9 details about role of the board of directors at the company?
- 10 a list of matters reserved for the board?
- 11 a list of board committees?
- 12 the existence of an audit committee?
- 13 the names on the audit committee?
- 14 the existence of a remuneration/compensation committee?
- 15 the names on the remuneration/compensation committee)?
- 16 existence of a nomination committee?
- 17 the names on the nomination committee?
- 18 the existence of other internal audit functions besides the Audit Committee?
- 19 the existence of a strategy/investment/finance committee?
- 20 the number of shares in the company held by directors?
- 21 a review of the last board meeting? (e.g. minutes)
- 22 whether they provide director training?
- 23 the decision-making process of directors' pay?
- 24 the specifics of directors' pay (e.g. the salary levels etc.)?
- 25 the form of directors' salaries (e.g. cash, shares, etc.)?
- 26 the specifics on performance-related pay for directors?
- 27 the decision-making of managers' (not Board) pay?
- 28 the specifics of managers' (not on Board) pay (e.g. salary levels etc.)?
- 29 the form of managers' (not on Board) pay?
- 30 the specifics on performance-related pay for managers?
- 31 the list of the senior managers (not on the Board of Directors)?
- 32 the backgrounds of senior managers disclosed?
- 33 the details of the CEO's contract disclosed?
- 34 the number of shares held by the senior managers disclosed?
- 35 the number of shares held in other affiliated companies by managers?

Removed items from our scoring

any industry-specific ratios?⁸⁴

its cash flow statement according to international accounting standard (IAS/US GAAP)?⁸⁵

⁸⁴ Industry-specific ratios are essential for the finance industry, which is excluded. We do not require them for other industries.

⁸⁵ In the European Union, the IAS format of cash flow statement is used.

Privatisation or re-nationalisation? – Views on state control over Russia's large enterprises

Peeter Vahtra⁸⁶

Harri Lorentz⁸⁷

Turku School of Economics,
Pan-European Institute

Abstract

The recent years have brought along considerable strengthening of the role of the state in key Russian industrial sectors. There are clear signs of re-nationalisation in the strategic natural resource-based industries in particular, where the Russian State has increased its direct ownership as well as levied indirect control mechanisms. The increased role of the state has inevitable consequences on enterprise performance and corporate governance. While the state ownership in Russia has often seen to result in negative outcomes, including enterprise mismanagement, weakened corporate governance practices and poor performance, the recent increase in state ownership and control has not undermined the overseas investor confidence. The stock issuances by large Russian enterprises have attracted considerable interest on world stock exchanges and the Russian companies are engaged in increasing numbers of international mergers and acquisitions. The key issue remains to reach the equilibrium between the economic and strategic interests in regard to state ownership and control in Russia.

⁸⁶ Researcher, Corresponding author, E-mail peeter.vahtra@tse.fi

⁸⁷ Researcher, E-mail harri.lorentz@tse.fi

Introduction

During the 1990s, the former socialist countries of the Commonwealth of Independent States (CIS) have taken considerable steps towards privatising their enterprise sectors to rebuild their industrial competitiveness through more efficient enterprise management and governance. At divergent levels, the restructuring has facilitated the economic upturn across the CIS, as the private enterprise sectors are gradually catching up with the Western corporate governance.

Within the CIS, Russia has been the leading country in terms of the share of private sector in a country's economy from the very beginning of the transition period. During the recent years we have, however, witnessed reversed development in privatisation in Russia. Initiated by re-nationalisation of some of Russia's most prominent oil assets, the state is evidently regaining control over the country's strategic industrial sectors.

The strengthening of state ownership through reformation of state holding companies and the introduction of hybrid forms of private and public governance has in many instances come at a price of destabilising the credibility of the Russian institutional and legal environment. On the other hand, the recent developments have thus far done little to undermine the investor confidence in the Russian economy; as indicated by several examples of the past year, the increased governmental support through strengthened control and ownership in many Russian companies has been one of the major drivers of the stocks of the companies involved both on domestic and international exchanges.

In the current article, we discuss the development of privatisation and corporate governance in Russia in comparison to other CIS, with subsequent presentation of related Russian company cases and discussion on ownership, control, and corporate governance in Russia, given the increasing state leverage in the country's industrial sector. While extensive international critique has been posted on the subject of re-nationalisation of Russian industrial assets, we attempt to provide constructive discussion on pros and cons of the increasing role of the state in the Russian economy. Aimed to facilitate discussion among policy makers, investors, and academics alike, we offer an insight into ownership and corporate governance issues of the Russian enterprise sector in regard to increasing state control over the Russian industrial assets.

Earlier research on ownership, control and corporate governance in Russia

In recent years, a number of scholars have studied the issues of ownership and control in the Russian enterprise population, and particularly in the major industrial corporations. For example, the management transformation of the Soviet enterprise, and the consequent implementation of new productivity criteria in Russia and the CIS, has been examined by Liuhto (1999a; 1999b). Enterprise history in terms of state involvement was found to be a significant predictor of performance. Generally, the studies on ownership, control, and the development of corporate governance in the Russian industry generally suggest high levels of ownership concentration on one hand, and superior performance and governance practices of private companies over the state-owned ones, on the other (e.g. Murav'ev 2003; Guriev and Rachinsky 2004). While both the agency and stakeholder theories have gained some support in explaining the development of corporate governance in Russia, the scholars have further recognised the possibility of Russia developing its own distinctive model of corporate governance, based on the conditions of its unique institutional environment (e.g. Puffer and McCarthy 2003; McCarthy and Puffer 2003).

In particular, the effects of ownership concentration on corporate governance have drawn the interest of scholars. Guriev and Rachinsky (2004) stress the high level of ownership

concentration in Russia, with the 23 largest business groups controlling more than a third of the sales in their sample representing the Russian industrial field. Guriev et al. (2004) conclude that the concentration of enterprise shares in the hands of a large shareholder has, up to a certain level, a positive impact on corporate governance. However, when too large a block of shares is consolidated by a large external shareholder, the effects of any further increase in their shareholding on corporate governance were found negative.

Earlier research has additionally focused on state shareholdings in Russia due to continuously high share of state ownership in the Russian industry. The results generally suggest lower quality of corporate governance in the state-owned companies. In their study, Kuznetsova and Kuznetsov (1999) pointed out the inability of the state to act as a responsible shareholder and to utilise its power to the benefit of the firms in which it had shares. According to Guriev and Rachinsky (2004), both the private enterprises controlled by minority shareholders and large external owners outperformed the state-owned companies in Russia. Similarly, Murav'ev (2003) concluded that the performance of the companies with state ownership was significantly worse than that of privately-controlled enterprises. As opposed to the common misconception that only the low quality assets were left under the state control, Murav'ev (2003) found the reasons for poor performance of state-owned companies in weak control over the companies and inadequate monitoring of managers. In a related study on mechanisms of state ownership in the enterprise sector, Kuznetsov and Murav'ev (2001) found management through a state holding company preferable to direct government control.

On average, the researchers have found the quality of corporate governance to be higher in large enterprises having lower unit costs of introducing corporate governance standards (Guriev et al. 2004). Similarly, McCarthy and Puffer (2003) cite that small Russian companies seldom have the resources to attract significant foreign investments and seek listing on stock exchanges, thus, lacking any major incentives for developing corporate governance. Corporate governance has been found to be an important factor of restructuring the privatised companies in all transition economies, improving relations among shareholders, directors, and managers (Filatotchev et al. 2003; Shekshnia 2004). Due to the aforementioned reasons, the large companies have been at the forefront of this development, being the first to become involved in corporate governance issues (McCarthy and Puffer 2003). In addition, Black (2001) concluded that the quality of corporate governance is highly positively correlated with market value of large Russian enterprises listed on domestic and foreign stock exchanges. Since the number of the latter has considerably increased in the recent years, we can expect the impact of good corporate governance to have diminished somewhat, but likely to remain significant.

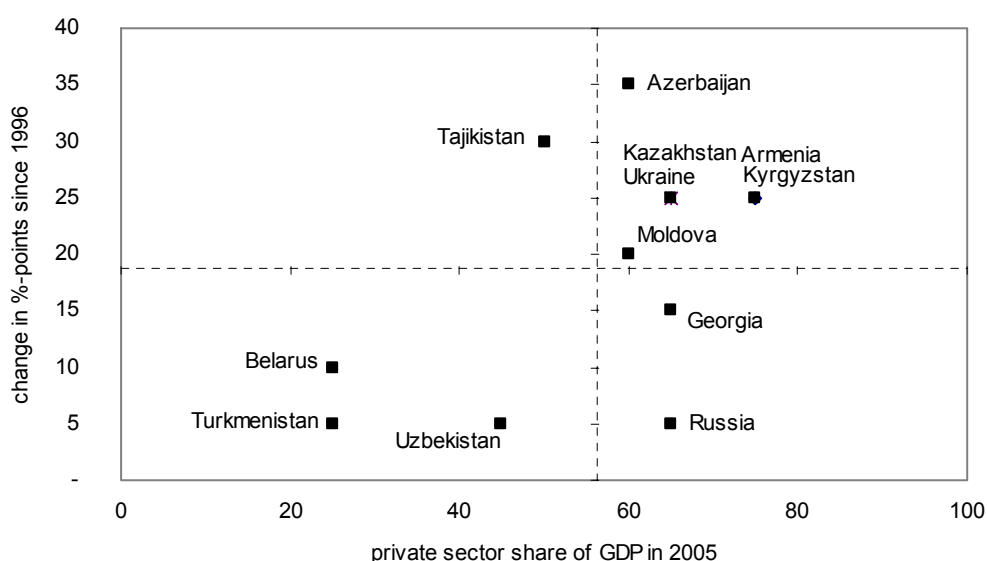
To conclude, the earlier literature indicates the relatively modest implementation of corporate governance practices in Russia. Additionally, the researchers have found the state ownership to have a profound impact on enterprise performance and corporate governance. In our current article, we focus on both issues by providing insights in recent developments of industrial ownership in Russia.

Macroeconomic overview on privatisation and corporate governance in Russia

In comparison to the other transition economies in Central and Eastern Europe, CIS countries in general have been more cautious in implementing transitional reforms in the area of enterprise restructuring. The European Bank for Reconstruction and Development (EBRD) assessment in 1996 categorises most of the Central-Eastern Europe and the Baltic States as "countries in advanced state of transition" and the CIS countries to the intermediate or low transition stage categories. The following review concentrates on the developments in the CIS.

The private sector share of the GDP in 1996 (the starting point for our review period) ranged from 15 to 50 per cent in all CIS countries except Russia, where the private sector share had reached 60 per cent in the wake of voucher-based mass privatisation schemes in the 1993-1994. More than 15.000 medium to large companies employing more than 80 per cent of the work force experienced ownership transfer to private entities. The cash-based second phase of privatisation was initiated in the beginning of 1995; a continuation of fast and revenue maximisation oriented policy, but in the end led to significant controversies. After 1996, the pace of privatisation in Russia has been slow, as a new approach aimed towards transparency and enterprise restructuring was taken by the government (EBRD 1996). Figure 1 plots CIS countries on the dimension defined by the 2005 level of privatisation (a rough estimate of the EBRD) and the pace of change during the last 10 years.

Figure 1 Development of privatisation during 1996-2005 in the CIS



Sources: EBRD 1996, 1997, 2004, 2005.

Ukraine and Kazakhstan among others have been active in their privatisation schemes during 1996-2005. They have reached similar level in the share of private sector of GDP as Russia, who achieved most significant development during the first half of the decade. Many of the privatisation plans were hold off and have not yet become part of the reality in Russia, a fact of which good examples are some of the major corporations in Russian industries. Belarus is a story of its own with changing registration policies during the late 1995 largely halting the privatisation and the corporatisation processes; therefore the position in the lower-left, poor-results/no-effort -quadrangle.

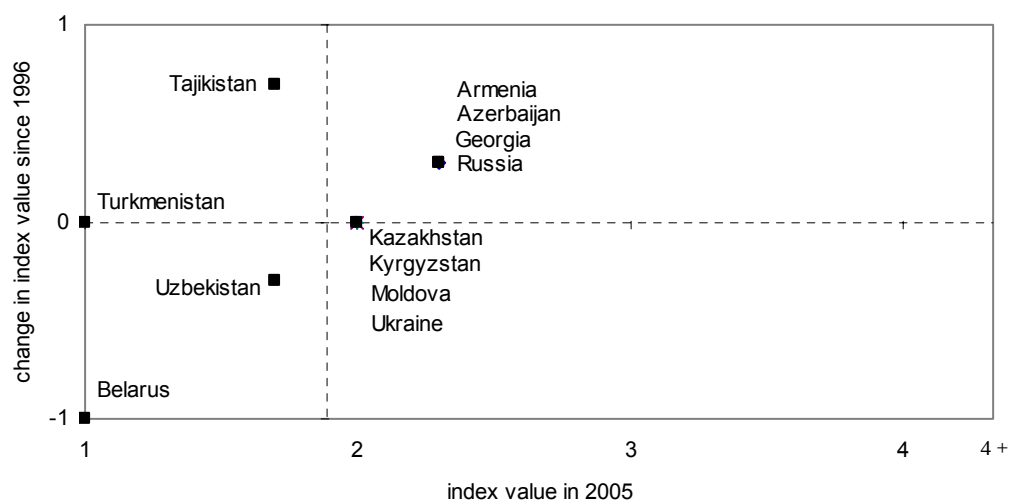
During the focus period the level of private sector share of GDP in the CIS countries has actually decreased only twice. The first of these rare occasions took place during 1998-1999 in Moldova, where the political situation has been somewhat unclear with signs of re-nationalisation souring the investment climate. The second is more recent and indeed interesting from this article's point of view: the indicator dropped from 70 to 65 per cent in Russia during 2004-2005. The reasons behind the negative development in Russia are predominantly the re-nationalisation of large companies in the oil and gas sector. In addition, the decisions to increase regulation in the "strategic industries", has increased the state involvement in the enterprise sector (EBRD 2005). The future will tell whether this divergent development from most of the other major CIS countries continues to broaden. Currently the

level of privatisation ranges from 25 per cent (Belarus, Turkmenistan) to 75 per cent (Armenia, Kyrgyzstan) among the CIS countries.

Enterprise restructuring and the development of corporate governance in the CIS, are also of significance in the scope of this article. Until 1996, the predominant source of restructuring had been the tightening of access to government subsidies and soft bank credits, as well as the increased scope for import competition and the liberalisation of new enterprise development. However, the implementation of stronger bankruptcy laws had so far been on the backburner. In Russia, the level of government subsidies to firms and individuals experienced a significant drop from 23 per cent of GDP in 1992 to approximately 2 per cent in 1995, demonstrating a significant improvement in restructuring of the enterprise sector (EBRD 1996).

In the area of corporate governance the newly formed financial-industrial groups pushed for improved management practices and corporate governance in their respective conglomerated companies (EBRD 1996). This favourable development during 1996-2005 in Russia, as well as in other CIS countries measured by the five category index for governance and restructuring⁸⁸, is depicted in the Figure 2.

Figure 2 Corporate governance and restructuring during 1996-2005 in the CIS



Sources: EBRD 1997, 1998, 2004, 2005.

The current state and the ten-year-change oriented set-up in the Figure 2, allows us to distinguish between above and below average countries in terms of current position, and the positive or negative development during the ten-year focus period. Russia managed to improve its position with the change of the millennium, by initiating reforms on bankruptcy laws in 2002, and due to the continued momentum from financial-industrial groups to

⁸⁸ The EBRD index for corporate governance and restructuring involves a five step categorisation:

- Category 1:* Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance
- Category 2:* Moderately tight credit and subsidy policy but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance
- Category 3:* Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (e.g. through privatisation combined with tight credit and subsidy policies and / or enforcement of bankruptcy legislation)
- Category 4:* Substantial improvement in corporate governance, for example, an account of an active corporate control market; significant new investment at the enterprise level
- Category 4+:* Standards and performance typical of advanced industrial economies: effective corporate control exercised through domestic financial institutions and markets, fostering market-driven restructuring

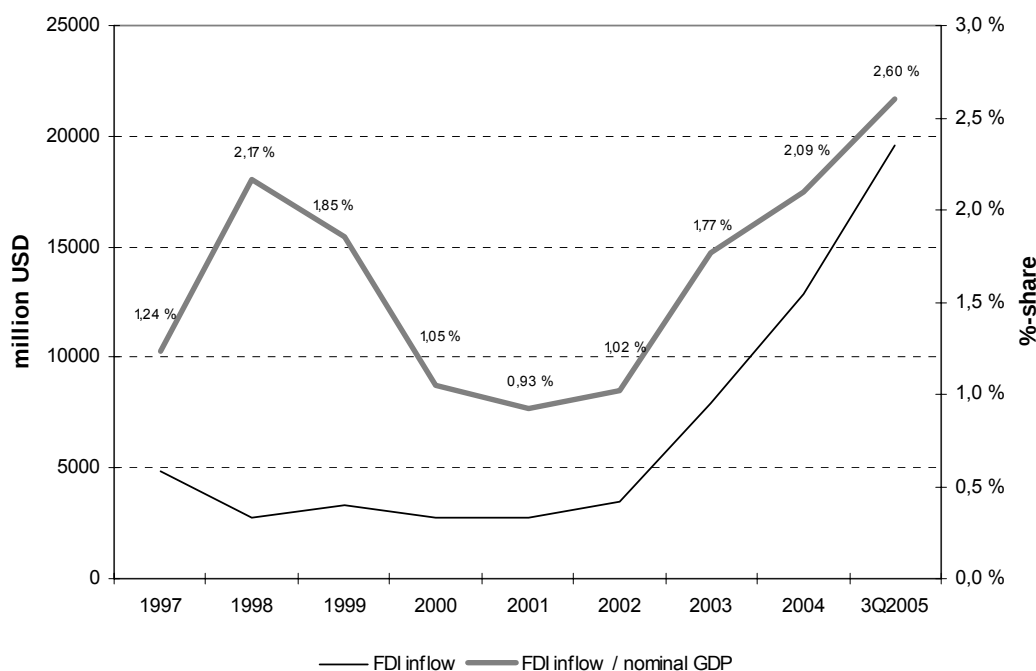
modernise corporate governance practises in large companies. However, due to the lack of stimulants from the areas of ownership right reforms and increased competition, the restructuring process is just beginning to take hold in many companies lesser in size.

Belarus is the underperformer of the group, while Ukraine and Kazakhstan perform above average even though they have not achieved any significant change since 1996. It is important to note, that in the five-step category of the index (1 – 4+), all the CIS countries lie in the range of 1 to 2.3, with only one country crossing categories into positive direction, namely Tajikistan. The changes have been marginal in proportions, if any. In real terms, there has been no significant improvement during the last ten years from the regime of *moderate policies and weak enforcement* in the area of corporate governance and restructuring in the CIS. The *significant and sustained action* in the promotion of corporate governance and standards of conduct seem to be lacking across the spectrum.

The above considerations on privatisation and corporate governance are important factors in determining the investor confidence and consequently the direction of economic development in Russia. Perotti and van Oijen (2001) argue that the resolution of political risk resulting from successful privatisation has become a significant factor in supporting the rapid growth in stock valuation in the emerging market economies (EME). The determinants of FDI in transition economies have been argued to correlate with for example country risk, which in turn is influenced by the private sector development in general (Bevan and Estrin 2000). In addition, Jensen (2002) has confirmed the significance of political factors, such as the level of economic reform and level of state capture by the political and economic elites, to the volume of transition economy FDI inflows.

Along these findings that establish the relationship of investor confidence and economic development in the form of both portfolio and direct investment contribution, we may take into consideration the observations on FDI inflows to Russia and integrate them to the previously presented elaborations on privatisation and corporate governance. Figure 3 depicts the development of annual FDI inflows during the last decade and plots the significance of the same to the Russian economy, namely the nominal GDP.

Figure 3 FDI inflows and its importance in Russia during 1997-2005



Sources: Russian Central Bank 2006; Rosstat 2006.

The bump in 1998 FDI inflow share of nominal GDP is mainly due to the financial distress of the time, as the value of the rouble depreciated against the USD. With relatively more stable exchange rate development after 2000, the figures are more informative. The accumulated FDI inflow during 1-3Q05 made 2.60 per cent of the Russian nominal GDP: a significant rise from the trough of 2001 with 0.93 per cent contribution. We can make cautious inferences that the favourable development in corporate governance as well as the stable and high share of the private sector in the economy has increased investor confidence, a fact that is confirmed by the A.T. Kearney's investor confidence ranking of Russia as the 11th most attractive market in the world (A.T. Kearney, 2004). However, while the ranking has already declined from the previous years due to unfavourable developments in the level of political risk, the FDI figures show no downward movement. This suggests a twofold impact of increasing state control in the Russian industry on the country's investment profile – despite the increased political risk in Russia due to state interventions in the enterprise sector the recent developments have not undermined foreign investor confidence. This paradox will be discussed in more detail in the following chapter.

Redistribution of ownership and control – a company-level insight

As indicated by the decreasing share of private sector in the Russian GDP, the past years have been marked with considerable increase in state control over the country's major industrial assets. Through a series of ownership arrangements initiated by the notorious probe around the country's once-largest oil producer, Yukos, the Russian State is effectively regaining the control over several companies in strategic industries. While widespread concerns have been voiced, on ownership rights, institutional development, and functioning of the legal system in Russia, the increased state control has not entirely been met with disguise – the turnover and value of Russian stock exchanges have hit record-high levels, and international investors are hailing the upcoming IPO's of newborn or restructured Russian state-owned companies on the major stock exchanges of the world.

Hence, when discussing the increasing state leverage and control over Russian industrial assets, we are bound to consider the matters of increased investor confidence and, in some instances, greater transparency delivered by state ownership of the Russian enterprises. In following, we provide three divergent company cases, which highlight the recent developments in the balance between public and private ownership in Russia. The brief company cases are followed with discussion on corporate governance implications of the recent changes in industrial ownership and control in Russia.

Gazprom: liberalisation and state control

Gazprom share market liberalisation and removal of the ring-fence initiated in 2005 is among the most significant recent developments in the Russian enterprise sector. After the collapse of Gazprom and Rosneft merger in 2005, the Russian government introduced an alternative plan and arranged a purchase of additional 11 per cent of Gazprom's shares, accumulating a majority stake in the company. As of the end of 2005, the government directly owned 50 per cent +1 share in Gazprom, while controlling additional 4.55 per cent through subsidiaries. Along with the accumulation of a controlling stake, the government has introduced a liberalization plan for Gazprom's shares, ratified by the president. Most importantly, the steps of implementation of the plan include lifting of limitations on trading of Gazprom's shares by foreign investors on Russian exchanges and lifting the 20%-limit on foreign ownership of the company's shares.

The dramatic shift in plans in just 12 months, from integrating Gazprom and Rosneft, to restructuring and liberalisation of Gazprom shares, implies strong backing at the highest federal level and interest of the state to gain the position of a dominant shareholder in the company. While removal of the ring-fence can be expected to deliver positive effects particularly in the field of corporate governance, the growing urge of the government to actively control the country's major energy assets should not be overlooked. As witnessed by another major event in Russia's energy sector in 2005, the liberalization of Gazprom shares came with a price of further consolidation of the sector.

In late 2005, Gazprom purchased 75.7 per cent of the shares in Russia's fifth-largest oil producer, Sibneft, from its principal owner, Millhouse Capital, associated with a Russian industrial magnate, Roman Abramovich. The \$ 13-billion deal, combined with the earlier overtaking of Yukos' main production subsidiary, Yuganskneftegaz, by state-owned Rosneft put the state in control of a third of Russia's oil production, compared to just below 4 per cent in 2003.

Svyazinvest: a long way towards privatisation

Svyazinvest is Russia's state-owned telecommunication holding and fixed-line monopoly, comprising several regional fixed-line operators. The government currently owns a 75%-share in Svyazinvest, valued at \$ 5 billion, with the remaining 25 per cent belonging to another Russian financial-industrial holding, Access Industries⁸⁹. As an owner of the blocking share in Svyazinvest, Access Industries holds the right to intervene in any future reorganisation of the holding.

The privatisation of Svyazinvest has faced numerous delays during the recent years, due to somewhat mixed interests of the groupings inside the Russian government. Included in the group supporting the privatisation are the liberal-minded top officials from the Telecommunications Ministry and Svyazinvest. The voices hindering the privatisation include the military and government security agencies, afraid of losing their preferential tariffs, and

⁸⁹ The principal shareholder of Access Industries, Leonard Blavatnik, bought the share from Mustcom consortium belonging to George Soros.

facing more operational restrictions with the Russian fixed line network in private hands. However, the two strategic groupings have already been promised preferred treatment and considerable subsidies to set up networks of their own once the Svyazinvest privatisation is completed.

The delay in privatisation implies certain strategic governmental interests around the holding. Despite the long-lagged process, the latest developments suggest the auction should be expected during the first half of 2007 at latest, as the government is narrowing the list of suitable buyers for its 75%-stake. As indicated by earlier developments in the process, the Russian government is not eager to hand over the control in a company that controls more than 70 per cent of the country's telecommunications infrastructure to a foreign owner. It thus remains obvious that the government is seeking the possibility to retain certain leverage over Svyazinvest by introducing a manageable domestic buyer for its stake.

AvtoVAZ: strengthening the control

Russia's largest carmaker, AvtoVAZ, has been one of the flagships of Russian machinery industry since the Soviet era. For the domestic car manufacturers, the development in Russian passenger car market in the recent years has been troubling at best. Weak quality of production, troubling financial conditions and growing demand for foreign cars have driven many domestic producers on the verge of bankruptcy. Moreover, the expected WTO membership of Russia has been predicted to hit hard on domestic automotive and other manufacturing industries.

In late 2005, the former owners of AvtoVAZ, led by Vladimir Kadannikov, swiftly sold out their shares in the company to undisclosed buyers. The event was followed by sudden change in the company's management, as more than 100 executives of the state-owned armament exporter, RosOboronExport, took control over AvtoVAZ. As suggested by the quick turn of events, the State seemingly has a definite goal of securing control over the car manufacturer. Currently, the state directly owns 2 per cent in the company, while the subsidiaries control 64 per cent. The likely scenario includes the state increasing its ownership in AvtoVAZ to a direct majority. As reported by several market observers, the governmental plans include formulating a state-run automotive conglomerate, which would include AvtoVAZ, the major truck manufacturer, KamAZ, and off-road vehicle and truck manufacturer GAZ.

As the case of AvtoVAZ indicates, the government is looking to increase its control over the key sectors of Russian industry even beyond the natural resource-based sectors. In many aspects, however, the increasing state control over the troubled carmaker may be regarded as positive development for the company. For AvtoVAZ, the acquisition essentially means even stronger state support and likely improvements in financial conditions; as a government-backed company, the credit profile of AvtoVAZ should witness major improvements among investors.

As indicated by the above cases, several divergent sectors of the Russian economy are currently undergoing significant changes in regards to ownership and control. The current restructuring of Russian industrial sector is essentially about striking a balance between public and private ownership, with both economic and political lines of consideration present.

As elaborated earlier, the impact of increased state ownership and control is essentially twofold. The deteriorating effects of such development occur both at the national and company levels. While the former category includes reduced credibility of the Russian institutional and legal environment as well as deteriorating ownership rights, the negative effects on the company level are more diverse. As the federal and regional governments regain stakes in private companies, the processes have more often than not included violation of the rights of minority shareholders. In addition, often being in positions of

operating companies for their personal benefit, the managers of state-owned companies have an unimpressive record of corporate governance violations. In addition, as indicated by several earlier studies, the state-owned companies have repeatedly been found inferior to private enterprises in terms of efficiency and performance. As indicated in the report by Troika Dialog (2006), the level of corporate governance in Russia deteriorated in 2005, along with a drop in the number of well-governed companies. While the reasons can be found in many contradictory ownership arrangements throughout the Russian industry, the increasing state ownership and related violations of minority shareholder rights play a notable role in this development.

However, to obtain a comprehensive overview on recent developments, one should not only focus on deteriorating effects of increased state ownership in the Russian industry. When many of the formerly private companies controlled by oligarchic groupings have poor transparency and disclosure records⁹⁰, state ownership is to considerably enhance the level of transparency of the companies involved. In addition, the financial support through restored state ownership may be viewed as a last resort for financially troubled and mismanaged enterprises of national strategic interest, such as the case company AvtoVAZ. Furthermore, while the international observers grow increasingly concerned over institutional and legal developments in Russia, the investment community has often welcomed the increased state leverage in Russian companies as a provider of additional stability on the Russian market. In an environment characterised by relatively high political risk, increased state ownership interests in the companies is often perceived by investors as offering additional safeguard against future political interventions. As a result, the planned IPO's of several majority state-owned companies have drawn enormous interest among international investors. Here, however, one needs to make a distinction between the positive reactions among the portfolio investors and often negative attitudes of strategic investors, who are likely to be more concerned about the increased state ownership and its deteriorating effects on enterprise development.

Conclusions

During 2004-2005, the private sector share of GDP in Russia decreased for the first time since the beginning of the transition period, indicating the increased state involvement in the enterprise sector. While the earlier studies generally confirm superior performance of private companies over the state-owned ones, the increased state ownership in Russian industry has thus far had little if any negative impact on investor confidence and FDI flows in Russia.

As indicated by the investor reactions, the impact of increased state control in Russian industry is essentially twofold. The detrimental effects of regained state ownership may include reduced credibility of the Russian institutional and legal environment, deteriorating ownership rights and purposeful mismanagement of companies and other corporate governance violations. On the other hand, increased state ownership has in some instances resulted in increased organisational transparency and assisted in improving the financial conditions of troubled companies. Furthermore, in particular the portfolio investors have regarded increased state ownership in strategically sensitive industries as a safeguard against unexpected political interventions.

Notwithstanding the positive reactions among the international investment community to increased state ownership in some instances, the long-term effects of increased state leverage are likely to include deteriorating enterprise performance, lower GDP growth rates, and weakening position of foreign firms in many industries. The recently increased strategic

⁹⁰ For instance Sibneft and AvtoVAZ have a long record of poor organisational transparency. Neither of the companies officially revealed the real structure of ownership behind the nominal shareholders.

thinking in the Russian economy suggests increasing limitations to foreign participation in several of Russian industrial sectors. In contrast, along with the upcoming WTO membership, Russian economy should become more open towards increased foreign participation through imports and, consequently, FDI. The question remains, how the balance between economic and strategic interests in Russian enterprise sector will be maintained.

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Section 6

Developing production systems in Russia

Value chains in Russian wood and timber sector: sources and obstacles to competitiveness – the example of furniture industry

Svetlana Avdasheva

Higher School of Economics (State University), Moscow

Abstract

Russian wood and timber sector recently demonstrates relatively stable growth in terms of output and labor productivity. At the same time, there are important factors decreasing the international competitiveness and performance. In 2004, for instance, Russia's export revenue in wood and timber industry was 2,5 times lower than the one of Finland and more than 6 times lower than the one of Canada. Traditionally low competitiveness of Russian wood and timber sector is explained by the low quality and when the quality is acceptable by the absence of quality, environmental etc. certification. But why should it be impossible for the Russian producers to meet these requirements during last 15 years? This could be considered as a puzzle.

The goal of the paper is to explain the incentives and opportunities for the restructuring of the Russian enterprises processing wooden materials on the example of furniture industry. Russian furniture market is demonstrating fast and stable growth, it is both attractive and promising. At the same time, many Russian furniture enterprises exhibit insufficient and inconsistent restructuring. On the basis of in-depth semi-structured interviews with different types of furniture market participants (furniture producers, including downstream integrated and specialized, retailers and suppliers of raw materials), the paper tries to explain modernization strategies of domestic furniture companies in the framework of value chain concept. Particularly, the article is aimed at explaining the obstacles for Russian enterprises to upgrade as a supplier of specialized products (parts of products), in spite of the experience that fragmentation of production became a way for successful restructuring in furniture industry of many former socialist Eastern European countries.

The main conclusions of the analysis are the followings. Underdeveloped domestic retailing and in particular the inability of retailers to govern value chain in efficient way make it necessary for furniture producers to choose between two alternative ways of upgrading, i.e. downstream integration, on the one hand, and entering into the chain of global specialized retailer IKEA, on the other. These two ways imply two opposite directions of restructuring. Following the first one, it is necessary to diversify, to expand product variety, to turn core business out from furniture production to furniture retailing. Following the other, it is necessary to specialize, to narrow product variety, to pay much more attention to product costing, etc. Two alternative ways of upgrading are perfectly substitutable: the same feature of furniture producer is an advantage on the one way and disadvantage on the other one.

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Introduction

Since 1998 the Russian furniture market has been growing rapidly. The annual growth rates 1998-2004 were about 10% in average. In the first years of economic recovery (1999-2000) it was the growth due to the expansion of domestic furniture producers, but since 2001 they have given place to import goods. In 2003 the threshold of 50% of the furniture market held by the import goods was exceeded. This evidence confirms that domestic furniture producers are not competitive enough. But why are they not?

This paper is an attempt to explain the low competitiveness of Russian furniture industry in the framework of value-chains concept. From the value chain perspectives there are at least two important questions to identify the level of competitiveness of a certain producer (cluster of producers). First, to what extent is the value chain the producers participate in competitive? Second, what is the location of a certain producer (cluster of producers) in the value chain? Even in a value chain which produces highly competitive products the value added by a given cluster of producers and the possibilities to upgrade for those producers may be small enough (Kaplinsky, 2004).

The performance of the participants inside the value chain depends on what stage of the chain is responsible for the rent created. The rents are associated with the stages at which entry barriers are the highest. These barriers are not static but dynamic; they are associated with the property rights on specific resources, both because of scarcity of natural resources, and because of uniqueness due to successful innovations. So, for the barriers and rent inside value-chain the Schumpeterian-type process of “*creative destructions*” is typical. All the value chains are divided into two types: driven by the producer and driven by the buyer. The “driving force” imposes some type of *governance* for the chain participants. The governance includes setting of standards (as *legislative governance*), monitoring the compliance of activity to these standards (as *judicial governance*), and assisting suppliers to meet the standards (as *executive governance*) (Kaplinsky, 2004). Therefore, the whole chain is affected by the policy of driving segment. Usually the participants who are able to govern value chain also appropriate rent. Here an important effect arises: on the one hand, rent is due to the use of specific high-valuable resources, on the other, driving force in the value chain may prevent other participants from upgrading and, therefore, may protect the ability to appropriate rent. The combination of these two effects, according to value chain approach, explains many features of modern international labor division and income distribution, including the puzzle why the participants of efficient value chains may have very bad financial performance and prospects to upgrade (Kaplinsky, 2004).

Value chain analysis has a relatively short history and still lacks clarity in terms of the choice of research approaches. Both theoretical and empirical studies have been undertaken, mainly since the early 1990-s, primarily at the Institute of Development Studies (United Kingdom, Sussex) which hosts working groups and conferences focused on the subject. The first book to thoroughly outline the main issues and to offer an analysis methodology was *Commodity Chains and Global Capitalism* (Gereffi and Korzeniewicz, 1994). *A Handbook for Value Chains Research* (Kaplinsky, Morris, 2003) was a significant (though not final) landmark in this evolution. A number of empirical studies have been undertaken since the mid-1990-s. No empirical studies devoted to the value chains in Russian wood and timber sector, to our knowledge, have been undertaken so far involving the methodology of value chains analysis.

At the same time there are research papers devoted to the trends in the furniture industry and other industries which belong to buyer-driven value chains development in transition economies. The success of former socialist countries in Eastern Europe (Czech Republic, Poland, Romania and Slovenia are among the fifteen major exporters of furniture in the world) is explained by specialization on parts of furniture (product fragmentation) and

outsourcing for MNCs and specialized buyers in the way of European Union integration (Kaminsky, Ng, 2001). There are also papers on the role of global retail company IKEA in restructuring of Russian furniture market (for instance, Tarnovskaya et al., 2005).

In accordance with the objectives of our paper, the results of the analysis of both international trends in development of furniture industry, especially in the developing countries, and the improvement of other value chains, driven by buyers, in transition economies are important. In the first place, these are the papers of Institute of Development Studies devoted to furniture sector in different countries. South Africa experience (Kaplinsky et al., 2002) shows that even if there are local comparative advantages in resource base, the absence of coordination between the participants in the chain (for South Africa – between sawmills and furniture producers) may prevent country's competitiveness in the world market. Indonesia provides the example of how the industry where informal activity is prevalent, can be at the same time more or less successfully integrated into global furniture value chain, with incentive to upgrade, provided by IKEA (Loebis, Schmitz, 2003). As for the second type of analysis, it should be noticed the explanation of vertical relation in agri-food sector, especially in dairy industry (Swinnen, 2005; Swinnen et al., 2006). As in furniture industry, in dairy and other agri-food sectors the development of efficient vertical contracts is of crucial importance for the market-oriented restructuring of the producers; and the critical role in the process belongs to the buyers, i.e. refineries and supermarkets.

The present study aims at testing the value chain analysis methodology as it applies to Russian furniture industry, at explaining the obstacles to Russian enterprises to upgrade and at discussing the implication of the analysis. The problem discussed implies much more than furniture sector only. To escape the trap of resource-dependent growth in Russia it is necessary that new industries and new sectors develop. The wood and timber sectors are definitely among the industries with rich growth potential and at the same time – with high risk of extensive and inefficient use of resources. On the one hand, the scale of timber cutting in Russia is less than ¼ of environmental safe level. On the other, products with low value added dominate in the structure of export in comparison with the products with high value added, which are relatively non-competitive. From the international perspective, there are examples of successful development of high value adding activities on the base of wood and timber. Finland, for instance, is an example of progress of the sectors with high added value based on forestry (Sutela, 2002). Success in value-adding sector requires new vertical relations within the existing chains as well as emerging ones and that makes the problem discussed of vital importance for Russia.

The paper is organized in the following way. The next section is devoted to the data and methodology. In section 3 the sources and obstacles to competitiveness of the Russian furniture industry are analyzed using “traditional” approach to competitiveness in order to explain why it is important but insufficient. Section 4 explains the relationships between the participants in the furniture industry value chains with different types of governance. The main objective here is to show how different types of governance influence on the ability and incentives of furniture industry enterprises to upgrade. Section 5 concludes with the discussion of challenges Russian enterprises face on the way to upgrading.

Data and methodology

The results of the in-depth semi-structured interviews with the managers of 21 companies producing and trading furniture in different Russian regions provide the empirical base of the paper. The interviews were conducted in autumn 2004 in the framework of the project “Ensuring Russian enterprise competitiveness within value chains” financed by the Ministry of Economic Development and Trade RF. Apart from furniture industry, pipe and tube value

chain was under consideration (Avdasheva et al., 2005). Table 1 presents the basic characteristics of sample in furniture industry.

The design of the sample meets the requirements of the project. Furniture value chain includes many successive stages: machinery, forestry, sawmills, furniture manufacturing themselves, wholesaling and retailing. Every stage of value adding needs supporting product and services such as seed and water for the forestry, chemicals, machinery and logistics for the sawmills, again specialized machinery, design, paint, adhesives and logistics for furniture manufacturing. The end of value chain is recycling and refuse disposal (Kaplinsky et al., 2003). In our project only part of value chain is under analysis from furniture industry itself (including parts of furniture) to retailing.

In the sample we tried to include the representatives of different types of participants in the value chain. On the one hand, we need producers (17 respondents) as well as retailers (4). Producers are divided into four sub-groups. The first one are companies which included in the value chain with neither global retailer nor domestic vertically integrated companies (respondents 1-5). The second group consists of suppliers (or former suppliers) of the global retailer (respondents 6-12). The third group is the only respondent being the largest domestic vertically integrated company (respondent 13).

Table 1 Sample description

№№	Position in value chain (operations completing)	Types of furniture produced	Region	Number of employees (2004)	Relations with main buyers in Russian furniture market	Respondent
1	drying, product design, assembling, wholesale and retail trade, after-sale services	kitchen suits, bedroom sets , cabinet units	Voronezh	1700	No	Head of manufacturing department
2	assembling, retail trade, after-sale services	cabinet units, kitchen suits, sliding-door wardrobes	Novosibirsk	25	No	Director
3	product design, assembling, retail trade, after-sale services, transportation	upholstered furniture sets, bedroom suites, kitchen suits, sliding-door wardrobes, beds, sofas	Novosibirsk	40	No	Consultant
4	board making, blank making, product design, semimanufacturing, assembling, wholesale and retail trade, after-sale services, personnel training, marketing, advertising	cabinet units, upholstered furniture sets, kitchen suits, sliding-door wardrobes	Novosibirsk	400	No	Regional wholesale manager
5	blank making, product design, assembling, retail trade, after-sale services, transportation, tailoring, marketing advertising	cabinet units, bedroom suites, kitchen suits, sliding-door wardrobes	Novosibirsk	10	No	Director
6	timber cutting, blanking, semimanufacturing, assembling,	cabinet units, wardrobes	St. Petersburg	500	Enterprise within the holding of global buyer	Director
7	timber cutting, blanking, product design, development of technologies, assembling, wholesale and retail trade, after-sale services, personnel training, advertising	Upholstered furniture sets	St. Petersburg	100	Supplier of global buyer	Commercial director
8	timber cutting, drying, recycling, blank making, product design, semimanufacturing, wholesale trade, personnel training, frame-house production, marketing, advertising	shelves, beds, bedside-tables	Mari El Republic	1150	Supplier of global buyer	Executive director
9	timber cutting, drying, recycling, blank making, product design, semimanufacturing, assembling, wholesale and retail trade,	sofas, beds, shelves, doors	Tver	440	Supplier of global buyer	General director

	personnel training, transportation , marketing, advertising					
10	product design, semimanufactures, assembling, wholesale and retail trade, after-sale services, personnel training, transportation, marketing and advertising	upholstered furniture sets, sofas, folding divans, armchairs	Moscow	400	Supplier of global buyer	Commercial director
11	timber cutting, drying, board making, blank making, semimanufacturing, product design, assembling, wholesale and retail trade, after-sale services, personnel training, transportation, mirror production, marketing, advertising	cabinet units, bedroom suites, sliding-door wardrobes, dinner-tables, writing tables, beds, chairs	Kirov	500	Supplier of global buyer	Commercial director
12	timber cutting, drying, waste recycling, board making, blank making, product design, semimanufacturing, assembling, wholesale and retail trade, personnel training	cabinet units, bedroom suites, writing tables, chairs	Tyumen	1240	Supplier of global buyer	Head of marketing department
13	all operations plus financial and research infrastructure	all kind of furniture	over Russia	3500	Domestic vertically integrated company	Deputy director on corporate governance and finance
14	accessories production	Accessories	Moscow	40	Supplier of domestic vertically integrated company	Executive director
15	Semimanufacturing assembling, wholesale trade, personnel training, marketing , advertising	bedframe, bedlegs	Kaluga	100	Supplier of domestic vertically integrated company	Commercial director
16	timber cutting, recycling, board making, semimanufacturing, personnel training, matches production, polygraph, marketing and advertising	wood fiberboard, chipboard, modified fiberboard	Kaluga	2150	Supplier of domestic vertically integrated company	Commercial director, financial director
17	accessories production, wholesale and retail trade	Accessories	Kaluga	130	Supplier of domestic vertically integrated company	Executive director
18	assembling, wholesale and retail trade, after-	-	Novosibirsk	12	No	Deputy

	sale services					director
19	product design, assembling, retail trade, after-sale services, personnel training	-	Novosibirsk	20	No	Manager
20	retail trade, after-sale services, transportation	-	Novosibirsk	15	No	Manager
21	retail trade, after-sale services, transportation	-	Moscow	15	No	Director

Source: results of the interview.

Finally, the fourth group is formed by the suppliers in the value chain of domestic vertically integrated company. Not all the respondents are producers of furniture or furniture parts. For instance, suppliers of domestic integrated company produce only raw materials such as boards, accessories etc. All the retailing companies are “one-shop retailers”, according to Kaplinsky’s classification (Kaplinsky, 2003). It may seem strange to interview only small retail companies, but this can be explained by the fact that in Russia there is practically no such market participant in furniture as *specialized buyers*.

It is easy to see from Table 1 that respondents are widely spread across Russian regions. Enterprises of very different scales are presented. Almost all of them are formerly privatized enterprises, a substantial part of them was sold after privatization, and almost each enterprise is managed by the executive director appointed after privatization and change of the main owner. In the time of the interview all furniture companies were in relatively good financial performance, none had losses. At the same time a remarkable share of respondents was quite skeptic as far as future performance is concerned. The main sources of danger according to the respondents are expected to be an increase of import to Russia, especially from China, a repeal of tariff preference on imported equipment and a decrease of import tax rate on furniture within the process of WTO accession.

Interviewing scenarios were designed on the basis of Kaplinsky/Morris’s methodology described in *A Handbook for Value Chains Research* (Kaplinsky, Morris, 2003). This toolkit is pitched to obtain expert assessments from respondents inside the value chain, permitting to characterize value chain patterns, to identify the composition and roles of their agents, and to explore the potential for increase in added value.

In the course of interviewing, all the respondents were asked a *basic set of questions* pertaining to the development of end markets for products, the composition of the value chain, barriers impeding access to the chain, major factors determining competitiveness of Russian companies on domestic and international markets. The basic set also included questions regarding consumers’ preferences and of their willingness to pay a higher price for product features relevant to them. The answer to these questions allowed to draw conclusions about the allocation of rents inside the value chain (on the example of wooden furniture). The common “nucleus” of questions permitted to verify information received through expert query from a variety of respondent types. The basic set was complemented by questions *specific to the value chain positioning of various agents*. In the interview scenario for manufacturers and retailers the emphasis was made on identifying market leaders, selecting suppliers, on determining the more relevant selection criteria, characteristics of relations with suppliers, discussion of product competitiveness and link-specific upgrading issues. Besides the respondents’ answers, statistical data characterizing the Russian furniture industry are used in order to check whether the picture drawn on the basis of a very restricted sample correlates with the general tendencies in the industry.

Analyzing the data of the survey we should keep in mind that the respondents’ answers reflect not only the market conditions as they are, but also the respondents’ perception. On the one hand, that gives us an advantage because we can draw conclusions not only about competitiveness in general but also how the directors of enterprises interpret the current situation, and therefore, what we should expect they choose as a main direction of upgrading. On the other hand, we should be extremely cautious interpreting some of the answers because Russian managers tend to overestimate their competitive advantages and at the same time the obstacles they face. In order to be marked out the respondents’ statements are in *Italics*. Finally, it should be emphasized that not all the respondents were ready to answer all types of questions (for the reason of trade secrets etc.). That is why further in the paper the number of answers received is specially indicated.

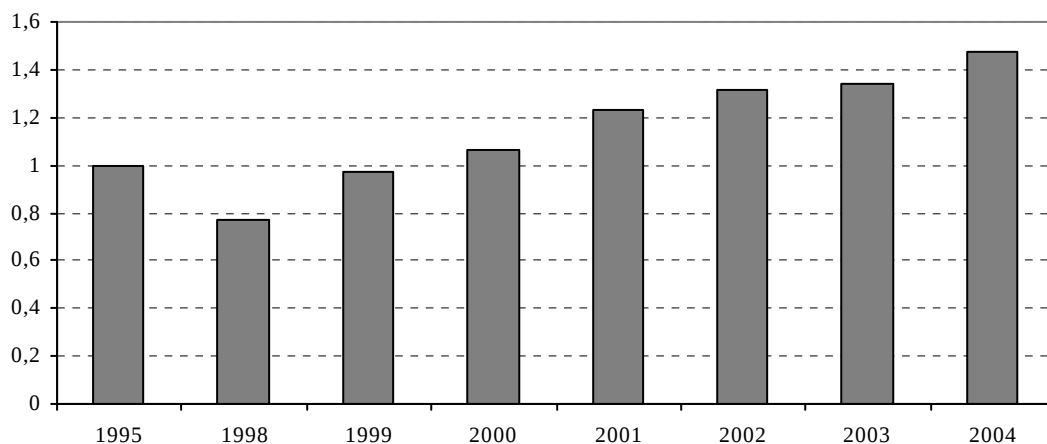
Sources and obstacles to competitiveness in the Russian furniture industry: a traditional view

Why Russian furniture producers have to be competitive?

Furniture industry is the one where there are strong predictions about high competitiveness and good financial performance of Russian producers after 1998.

First, from the beginning of the reforms the producers benefited from the large unsatisfied demand on furniture. During the late soviet period furniture was in short supply. The main obstacle to the huge increase of industry sales immediately after 1992 liberalization was a sharp decline of Russian citizens' disposable income. So, the increase of salaries since 2000-2001 should have resulted in a remarkable market growth (as it really was, see figure 1). From 1998 to 2004 the average annual growth rate of furniture market in Russia in real terms was about 10%. According to the State Statistical Agency RF (Rosstat, hereafter), the annual retail purchases of furniture in 2004 was about 3,6 bn euros and these data definitely underestimate the market due to large informal sector.

Figure 1 Sales of furniture in Russia in real terms: 1995-2004, 1995=1



Source: Russian annual statistical survey-2004 by the data of retail trade, author's calculations.

Second, though the Russians exhibit stable preference towards imported furniture as being of better quality, domestic producers have country-specific advantages in manufacturing the kind of furniture that you will never meet over the world. The striking instance is "Malyutka ("little one") sofa", folded in three, very suitable for a typical Russian room with little space. Regardless of tastes, preference, advertising and quality reasons, "Malyutka sofa" will remain among the most popular kinds of furniture until the whole style of living in Russia (including type of housing) changes. The same is true for many types of furniture including kitchen suites, bedroom suits, and upholstered furniture and so on.

Third, furniture is a labor-intensive industry, in which lower wages in Russia should be a competitive advantage. For our sample the average share of labor cost in the total cost of enterprise is about 20% and doesn't exceed the threshold of 30%, while in the European Union this share averages about 70%.

Fourth, in the sector of wooden furniture domestic producers can rely on the wide national resource base, including growing production of chipboards, fiberboard, etc. Potentially the domestic board should be of relatively good quality and affordable prices (unfortunately it is not always so, as we will see from the interview, but the existence of domestic resource base is incontestable).

Fifth, Russian vast expanses leave room for the local producers of goods which require high transportation costs. Since furniture is not a very compact kind of commodity, it remains true. Last but not least, up to now there have been relatively high import tariffs on furniture in Russia. Custom duties on furniture products during last five years are constant on the level of 20%⁹¹. Of course, importers try to evade duties as they can. On the popular way to decrease custom fees is to declare furniture (which is transporting non-assembled) as wood fiberboard. In spite of all that, we know that competitiveness of Russian furniture producers is not high enough. The share of imported products sold in Russia declined after national currency devaluation in 1998, but after that it has demonstrated stable increase. According to the data of retail trade in 2003 the share of imported products in value of furniture bought by the Russians was 53% and in 2004 it achieved the threshold of 60% (Social situation and living standards in Russia, 2004, 2005).

Why Russian furniture producers have to be non-competitive?

Let's refer to our sample to explain why the producers in the sample (thinking of them as representatives of the industry as a whole) could be of low competitiveness. First, from the international perspectives most of these companies seem to be too large. Table 2 shows that this is not intermittent error of our sample: the Russian furniture industry as a whole is dominated by relatively large establishments⁹². If the size of an enterprise exceeds the efficient one, this would provoke diseconomies on scale.

Table 2 International comparisons of furniture industry structure by size of firms

Country	Year	Percentage of establishments by size		
		<20	20-99	>100
Sweden	1992	92,5	6,2	1,1
Germany	1987	89,3	-	10,6
South Africa	1993	67,6	26,0	6,3
Italy ^a	1986	75,1	18,0	6,8
Russia ^b	2002	11,8	27,0	61,2
Russia ^c	2002	24,0	14,8	61,2

Notes:

^aThe Italian data distinguish enterprise size categories as follows: 1-49; 50-99; >100.

^bThe Russian data according to the size categories as 1-19; 20-99; >100.

^cThe Russian data according to the size categories as 1-49; 50-99; >100.

Source: Dunne (1999). Condensed version is reproduced from Kaplinsky et al. (2003), The Russian data are from the author's calculations based on the data of companies' annual reports to the Russian State Statistical Committee. Year 2002 was the last when companies were obliged to report the number of employees.

Second, the output of a typical company is highly diversified. Even small enterprises have product variety of at least 4-5 items. Again, under certain circumstances we could expect diseconomies on scope. It seems not accidental that suppliers of the global buyer (which should be more competitive than the industry on the average) are at the same time more specialized. Among other operations carried on within company's boundaries, the mysteriously frequent appearance of *marketing and advertising* needs to be explained below.

Third, the degree of vertical integration is quite high. Again, it is a characteristic feature not only for furniture industry, but for a great deal of privatized enterprises in Russia. Kakha Bendukidze, one of the most famous entrepreneurs in Russia (now minister of economy in Georgia),

⁹¹ Custom duties are so-called combined: 20% on custom value but not less than 0,6 - 0,85 euro/kg (for different items).

⁹² The result of calculation should be interpreted very cautiously because of large number of dropped data in the enterprises' statistical reports. For the year 2002, from about 2500 registered as working companies in Russian furniture industry (OKONH 15271) only 310 establishments reported the employment data. But even though all the enterprises with dropped data belong to the categories of establishments with less than 100 employees (what is extremely unlikely) we should conclude that industrial structure is shifted towards relatively large companies.

compared a typical Russian enterprise at the beginning of privatization with the *Mysterious Island* (the name of Jules Verne's novel) (Bendukidze, 2003). In the *Mysterious Island* Captain Nemo had to grow up all he needed, the same as the director of a Russian enterprise got use producing all the inputs. To diminish the scale of the activity out of core competence and to outsource are important components of restructuring for almost all Russian companies. Unfortunately, high level of vertical integration is not only Soviet legacy. High transaction cost and unsatisfactory vertical coordination make integration the most successful and widespread form of coordination in Russian market (see, for instance, Swinnen, 2005). In the international context, however, Russian companies seem to be outweighed by the activities out of core competence, and this could restrict competitiveness seriously. Sometimes the employment in core business is less than the employment in adjacent activities. In one of furniture producing companies in our sample, for instance, half of 400 workers are employed at transportation unit only.

Fourth, there are limitations for competitiveness of furniture producing in the adjacent technological chains. The Russian machine-building industry doesn't produce the necessary equipment of satisfactory quality. The same situation is with the accessories: the use of domestic accessories leads to losses of competitiveness of final products. The share of imported components in inputs is high enough (up to 80% for the companies in the sample with the average is between 30 and 40%). Exceptions are the enterprises producing cabinet units, beds, boards, shelves etc., the main components of which are domestic boards. These enterprises typically spend on imported purchased materials not more than 10% of current costs.

In the fifth place, most respondents use obsolete equipment and technologies. This gives rise to at least two specific features of management in the Russian industry (not only plants, producing furniture) with far-reaching implications. The first is that obsolete equipment prevents flexibility of product variety and production management. Several respondents said: *"to be competitive we have to adopt production facilities according to the needs of design... But what we do is the opposite: our design is adopted according to what is available using our equipment"*.

The second feature is that managers rely upon momentary, not strategic decisions in the sphere of technology. Moreover, they see the possibility to implement a kind of home-made equipment as an advantage. One respondent told the interviewer the following story: *"We needed a machine, which costs about 50 thousands euros and is produced in Italy. I showed the picture of it to my friend Michalych, who works for a military plant and asked him, whether he could assemble the same. He could, and you see, I have it only for 7 thousands"*. Not discussing the ability of the smart engineer Michalych to assemble the machine by picture, it is necessary to emphasize that the reliance upon *Michalych's wisdom* is quite common for Russian directors, and could be of remarkable importance in the future. In short, Russian production managers even if they have money for restructuring, could spend them on *Mychalych-made* equipment.

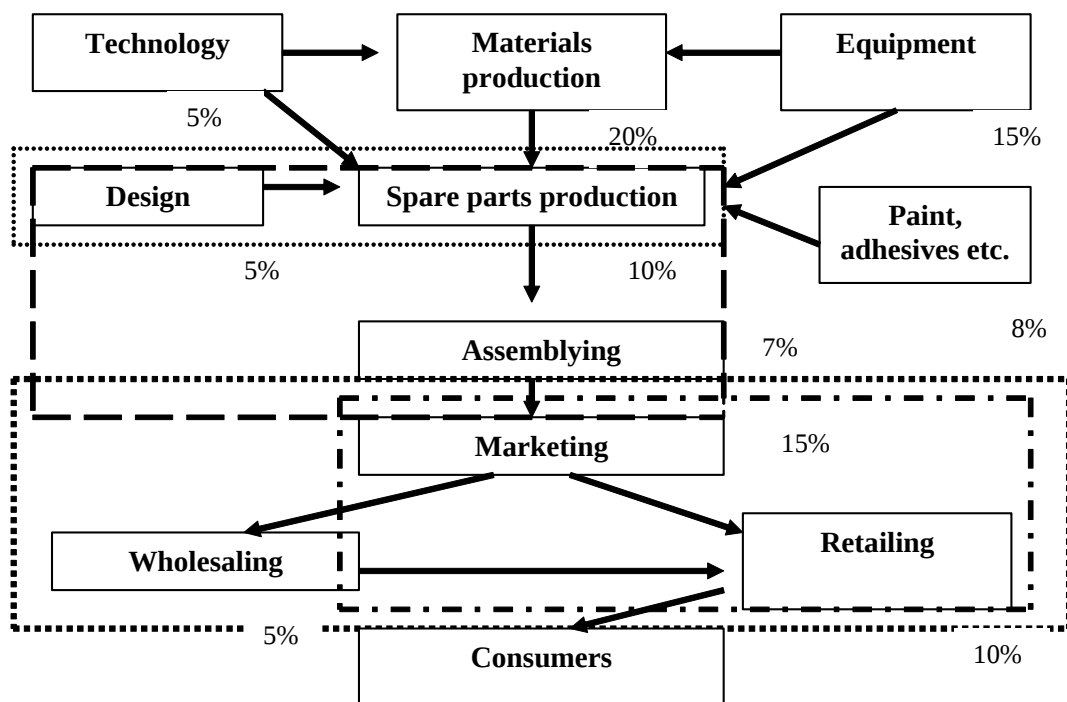
All these premises are important but they cannot explain why very few Russian furniture enterprises can overcome obstacles to be competitive. Why during the last fifteen years it was difficult to adjust employment and product variety, to attract financial resources and to renew equipment in order to use advantages of location and domestic resources? The transition period seems to be long enough to adapt to new economic environment. To answer these questions it is necessary to analyze the governance in Russian furniture value chain and incentives of economic agents in it.

Prospects for competitiveness in the Russian furniture industry from the perspective of value chain theory

Russian furniture industry: types of value chain organization

As it was mentioned above, furniture industry belongs to the buyer-driven value chain. Wholesale and especially retail trade is characterized by significant entry barriers, which mainly have to do with the need to possess a brand, to offer a broader slate of services to the consumer and to organize product promotion. Therefore, a considerable part of value added generated in this chain is accounted for marketing, while production of components and assembling of furniture claims on a smaller share of overall value added. Figure 2 presents the contributions of the successive stages of production and retailing to the whole sum of value added, on the example of wooden furniture.

Figure 2 Value chain and value added distribution in the Russian wooden furniture (2004).



Note*: The value chain includes functional links but not the types of companies. However, the figure demonstrates typical options of Russian companies' organization inside the chain.

Source: author's estimates on the base of the interview results.

Another segment with rather high entry barriers and a significant share of rent is the production of chipboard and fiberboard (especially chipboard). Virtually all Russian producers of cabinet units note that the availability of chipboard is a bottleneck for output expansion. The special role of chipboard in the Russian value chain is proved by the fact that IKEA, a company which on other national markets usually invests exclusively into design, marketing and retail infrastructure, pursues a different policy in Russia and invests into the build-up of its own capability for chipboard and fiberboard production (*Swedwood Tikhvin company*). Other foreign companies are also active in this segment: according to current estimates, to 2010 every second board in Russia will be produced by the foreign-owned producer.

There are three alternative types of governance in Russian furniture value chains: market-based, hierarchical, and modular. The most interesting options in terms of value chain upgrading are the latter two. Market-based governance is mainly the legacy of the Soviet system of sales whereby independent producers supplied their products to independent wholesale warehouses and retail outlets. The industry segment organized along these lines has been shrinking consistently in recent years. On the contrary, segments with vertically integrated, hierarchical and modular governance systems have been displaying a swift growth rate.

Vertical integration as a type of governance is presented by several Russian companies, most known of them is *Shatura*. Founded thirty years ago, privatized and restructured ten years ago, *Shatura* became a *great expectation* of domestic furniture industry in 1999, when its annual growth rates rose up to 30-40%. Recently growth records and financial results became modest, but still *Shatura* is considered the only domestic company that can compete with the global buyer *IKEA*. *Shatura's* share in domestic furniture production is about 12%, correspondingly, the market share is about 6%. The company provides several types of furniture, but specializes in wooden products. The furniture produced is bedroom suites (50%), office units (30%) and other furniture from wooden or wooden-modified boards (20%). Other types of furniture (upholstered furniture, first of all) are supplied to the *Shatura's* shops by other furniture producers. Product variety of *Shatura* is oriented to middle-income consumers, so the target market is the same as that of *IKEA*. The trademark *Shatura* is the only national brand in furniture, known almost by every Russian (at the time of the interview the ratio of brand recognition was 70% in Moscow and 58% over Russia). *Shatura* is almost completely oriented to the Russian domestic market, exporting only to Kazakhstan and the Ukraine. At the time of the interview export to Europe was organized, but, as a respondent indicated, *out of sporting interest only*. The company becomes not only a big producer but also a big retailer.

The biggest actor implementing modular type of governance is *IKEA*, a global buyer active in Russian market since 2000. Five big furniture supermarkets opened in Moscow, Leningrad region and Kazan, it's expected that this presentation will increase in the nearest future. *IKEA's* share in Russian furniture market is about 8-10% (derived from the evidence that 20% of furniture import in Russia is *IKEA's* import and the share of furniture produced by the domestic enterprises and sold in *IKEA* stores is 15-20%). About 75 domestic furniture producers are suppliers of *IKEA*.

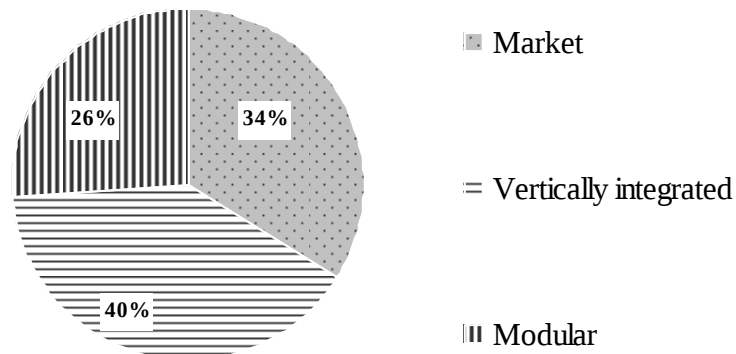
Figure 3 depicts the weights of different types of governance in the supply of Russian furniture enterprises. The most important channel of sales is the companies' own retailers. Even the companies which are not included in the vertically integrated or modular-governed chain prefer not to supply to Russian retailers. Instead, sales at the factory (as a sort of retailing without using specialized retail capacities), widespread in the early 1990-s, are present even now. From this perspective, the global buyer replaces not the independent retailers, but the development of retailing capacities by the producers. And here again, integrated and modular types of governance in the industry are prevalent.

Most part of the companies working in the framework of vertically integrated chains are supplying for the local markets only. Certainly vertical integration by the companies of small size could not be competitive enough in comparison with all-Russian or global retailers. Instead, suppliers either of global buyers or domestic vertically integrated companies (as well as rather large integrated companies themselves) supply to the all-Russian market. Suppliers of the global buyer are the only exporting producers in the sample. It is also characteristic of the Russian furniture industry: *IKEA* accounts for over 50% of very modest amount of furniture export.

Why market type of governance is so unattractive for furniture enterprises? To answer this question it is necessary to stress the common feature of any type of supplier-buyer relationships in Russian industry and that is fierce competition on the level of furniture production. Producers

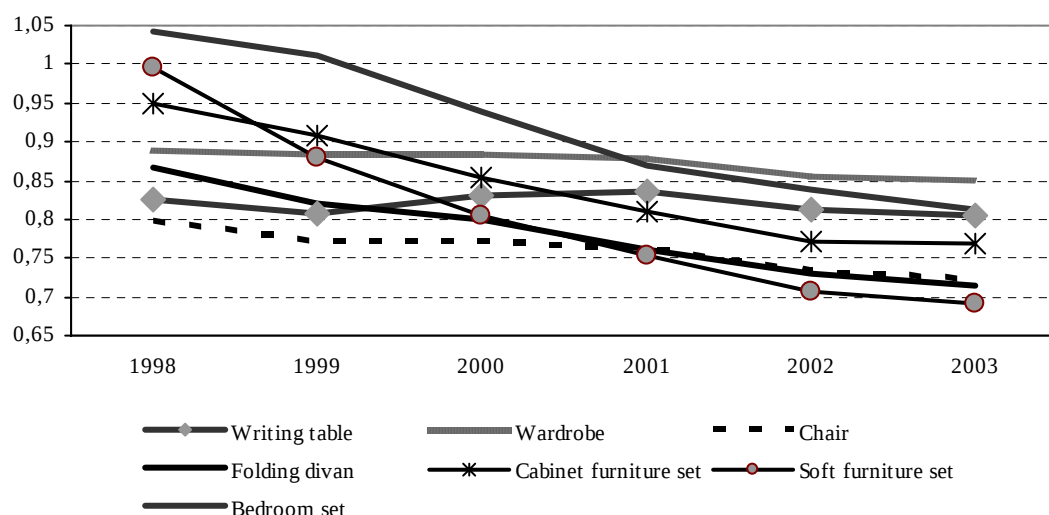
feel the competition they face is tougher than one on the level of raw materials production as well as retailing. The data of the dynamics of average furniture prices (figure 4) confirms the conclusion on strong competition in the domestic furniture market: during six years the average prices on different types of furniture reduces from 15 to 30%.

Figure 3 Organization of sales by furniture producing enterprises, % (weighted average by the employment, 10 respondents)



What are the results of the competition, which should provide market participants with incentives to upgrade? For the buyer (whoever it is – a vertically integrated company, a global buyer or a one-shop retailer) there are unrestricted opportunities to change the supplier, therefore, upgrading by the given supplier is not of serious importance for them. Let's illustrate that comparing the perception of crucial success factors by different types of market participants, on the one hand, and requirements of retail and vertically integrated companies for their own suppliers, on the other.

Figure 4 Real prices of selected items of furniture sold in Russia: 1997-2003; 1997 =1

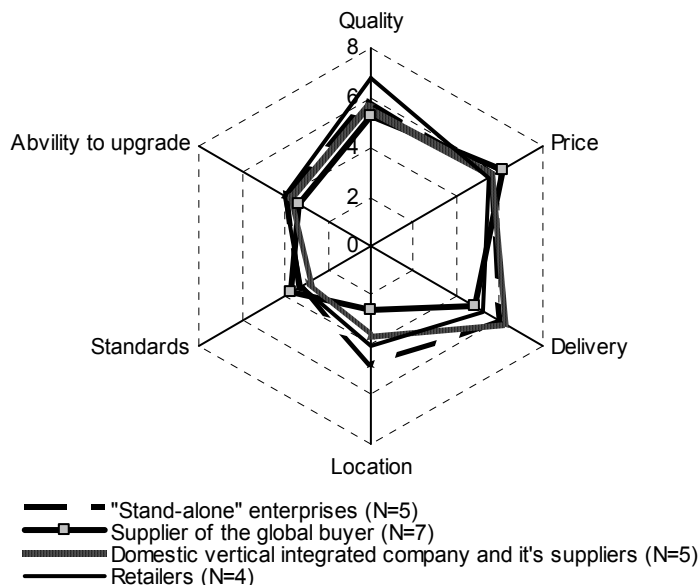


Source: Prices in Russia-2002; Prices in Russia-2004, author's calculations)

Types of value chain, opportunities and incentives to upgrade

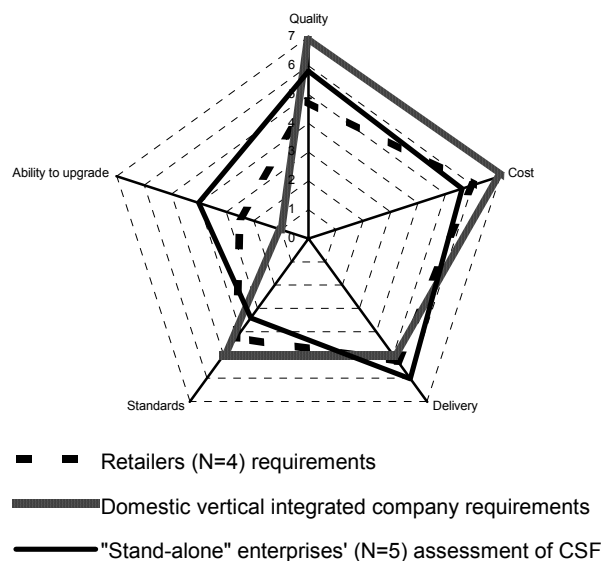
As far as overall estimations of crucial success factors are concerned, different types of market participants are almost unanimous (figure 5). The estimates received highly correlated with the ones presented by Kaplinsky (Kaplinsky et al., 2002). Quality and delivery are most important; the ability to upgrade is of medium importance. The only serious difference is that standards, according to market participants, are not so important in Russia in comparison with international practice.

Figure 5 Crucial success factors for producers in perception of different groups of market participants: from 1 – not important to 7 – extremely important



The picture changes if we compare the perception of crucial success factors by market participants with the requirements of buyers – retailers and domestic vertically integrated company (figure 6). We can see that the ability to upgrade for one-shop retailers is of modest importance. Instead, the price is more important for them than furniture producing companies are expecting. Formally retailers assessed the quality of products high enough, but the spirit of interview as a whole was that, from the perspective of retailers, Russian producers should compete for the market segment with low willingness to pay and a low level of consumers' expectations about quality. Domestic vertically integrated company is even stricter to its suppliers: price, quality and certification are of primary importance, but ability to upgrade is not interesting at all.

Figure 6. Crucial success factors in perception of producers and requirements of one-shop retailers: from 1 – less important to 7 – extremely important



The materials of interviews with producers also give an impression that Russian retailers and vertically integrated companies put pressure on furniture producers to cut prices but definitely don't assist them in upgrading, to the contrary of international evidence, presented by Kaplinsky (Kaplinsky, 2003). Questions to furniture companies about their relationship with suppliers showed that they implement the same type of practice for their own suppliers: there are no special attempts to provide suppliers with specifications or any standards and to support them to achieve the goals set up by buyers. According to market participants, in the context of extremely fierce competition the very threat of breakup of delivery contract should provide strong incentives for suppliers.

Ideally, fierce competition should induce the strong incentives to upgrade. In fact, the structure of incentive is shifted towards cost minimization. Considering the trade-off between price and quality, all the retailers were sure that their target consumers prefer lower quality at a lower price. In the context when buyers are not willing to pay premium on certification or ability to upgrade (in terms of product variety, quality etc.) the cost reduction becomes the main track of development. As a result, domestic producers can compete with the foreign ones (first of all, the Chinese) only in the lowest price segment.

Our information about the retailing in Russian domestic furniture market confirms the impression made by interviews with producers. Most specialized retailers (except the global buyer of course) are small and unable or reluctant to provide furniture producers any services which would help them to upgrade. Besides, it is important that retailers usually do not compose the bundles of furniture produced by different enterprises; they just display the furniture items for sale as they arrived from the producers. That is why almost all furniture producers, including very small ones, indicated operations inside the enterprise include marketing and advertising. That is why enterprises still use *sales at the factory* as important channel of product distribution. One respondent said: *"To sell at the factory... to sell in a furniture shop... It's just a trade-off between number of consumers (who may not arrive at the factory) and discount to retailer"*. From the value chain perspective, it is not the domestic specialized retailers who govern the value chain, but instead, furniture producers who perform the role of retailers themselves.

Recently several big furniture retailing centers have opened in Moscow and other big cities (*"Tri Kita"*, *"Grand"* and others), but till now the most difference between them and small retailers is that furniture of large number of producers (including domestic and foreign ones) are presented there. Up to now these centers have served mostly as exhibition places, as most consumers

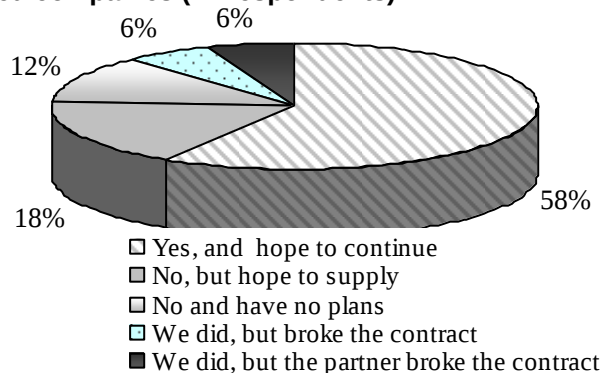
first choose furniture there, and then buy it directly from the producer with discount about 10-15%. To conclude, domestic retailing companies do not govern value chain in an appropriate way, do not give producers impulses to improve, and therefore, independent retailers are hardly competitive in the long run.

There are two alternatives to the market governance in the Russian furniture market: modular and vertically integrated. Comparing the relationships between the global buyer and the suppliers in Russia, on the one hand, and in international context (according to (Kaplinsky, 2003)), on the other, we can find similarities as well as differences. Like in international practice, the global supplier promotes the process upgrading more actively than product upgrading. More precisely, the only way of product upgrading provided for furniture producers by the global buyer is the specifications of products supplied. In some cases, according to the respondents, they were important enough to increase the quality of the product produced. At the same time, comparing with the evidence presented by Kaplinsky, the global buyer in Russia is far from implementing all the devices to promote upgrading by the supplier. Among the basic tools (which are specified as “work with suppliers”, “set targets and comply”, “provide finance”, “provide training” and “promote supplier cooperation” (Kaplinsky et al., 2003)) in our sample we found only two ones. Of six respondents which are or used to be suppliers of the global buyer, four pointed out that the buyer worked with them actively and set very hard but provoking to upgrade targets. No one pointed out that the buyer provided finance and training program for them while almost all (five out of six) said that they derived a lot from “learning-by-doing”. Several respondents have heard that the global buyer provided credit to Russian furniture producing companies but none of them is presented in our sample.

As for certification which is an important part of upgrading strategy, suppliers of the global buyer have advantage over the rest of the respondents, but at the same time their success is modest. All the six respondents had only quality standards (ISO9000), four of them introduced labor standards. They also meet standards of forest using, many of them are obligatory for the Russian industry participants, but very few keep them. For instance, suppliers of the global buyer demand that their own suppliers of wood should have cutting certificates to confirm the legality of timber cutting. All the companies pay for all the stages of certification themselves.

Like in international practice elsewhere, the global buyer protects its control of the key resources, first of all, of brand name and design. Products supplied to the global buyer, similar parts and products of similar design can not be sold to other market participants. As international practice, all furniture supplied is sold under the brand name of the global buyer. In exchange to relatively high amount of supply, profit margin is set on the level about 2-4 percent which in the period under consideration was substantially lower than average. Only one respondent indicated that the profit margin in the contract with the global buyer was on the same level with other contracts.

Figure 7 Answers to the question: Do you supply to global retailer and/or domestic vertically integrated companies (17 respondents)?



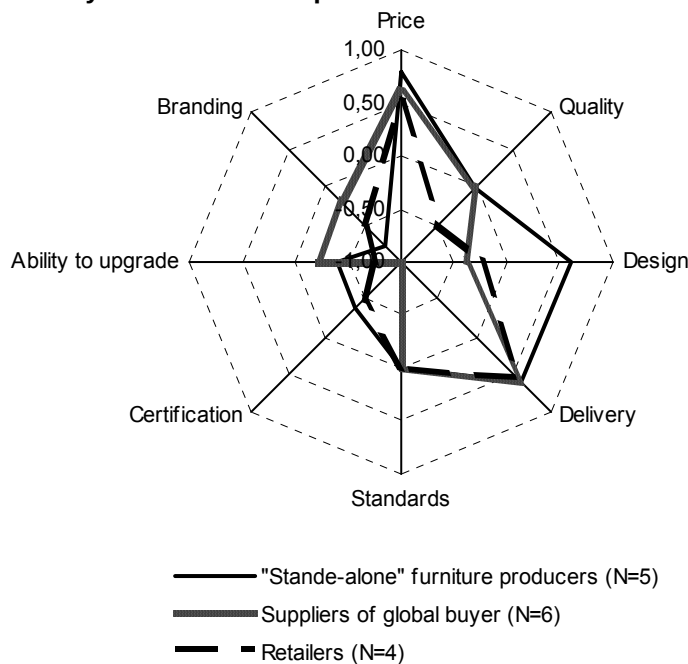
Nevertheless, almost all furniture producers in the sample prefer to be included in modular and/or vertically integrated relationships. Of seventeen producers interviewed only two said that they had no plan to become a supplier of the global buyer or a domestic vertically integrated company (figure 7). Producers indicated specific types of gains they derived supplying to the global buyer. In relative terms, the advantages are the highest for medium-size and narrow specialized companies. Two respondents with higher employment said that the improvement of internal organization, certification, quality, etc. was achieved independently of their contracts with the global buyer. On the contrary, suppliers with up to 500 employees highly appreciated the contribution of the buyer to their restructuring.

Vertically integrated companies in Russia historically started with production of furniture and then develop retail and marketing segment. Strategy of vertical integration is implemented consistently, with few exemptions (timber-felling is an example). The biggest company's assets include two furniture factories, a chipboard factory and a trading house. The company only purchases timber for chipboard production, hardware, adhesives, paintwork materials, accessories, and uses the services of several transport operators. Two major suppliers account for over one third of inputs. There is no particular governance towards suppliers: none of the suppliers of vertically integrated company indicated that the buyer promoted upgrading, except the control over quality. So the typical gains from the supplying to vertically integrated company are stable and relatively high amount of sales and the reputation of a high quality producer for other buyers.

Vertically integrated companies also try to establish more strong control over the final link in the value chain. It is indicative that the biggest company during a short period of fast growth relied upon the network of retailers-franchisee but is currently restructuring the system of product distribution shifting from franchisee to the company's own retailing. This process was initiated in spite of clear understanding that it will lead to slowing down of sales growth and can result in deterioration of overall financial performance within the next few years.

Integrated companies relying on upgrading through repositioning in the value chain focuses on the product renewal and aggressive market strategies. At the same time, according to the results of the interviews, insufficient attention is paid to the optimization of the production process and cost management issues. Headquarter of the company do not only failed to pay great attention to cost-saving, but also often lacked sufficient information on the level, structure and major determinants of final product costs. By the time of the interview, the company had not introduced system of product costing.

Figure 8 Competitive advantages of domestic furniture in comparison with imported one by the enterprises not supplying to the global buyer and domestic company (enterprises 1), suppliers of the global buyer and retail companies



Note: 1 – domestic producers are more competitive; - 1 – domestic producers are significantly less competitive.

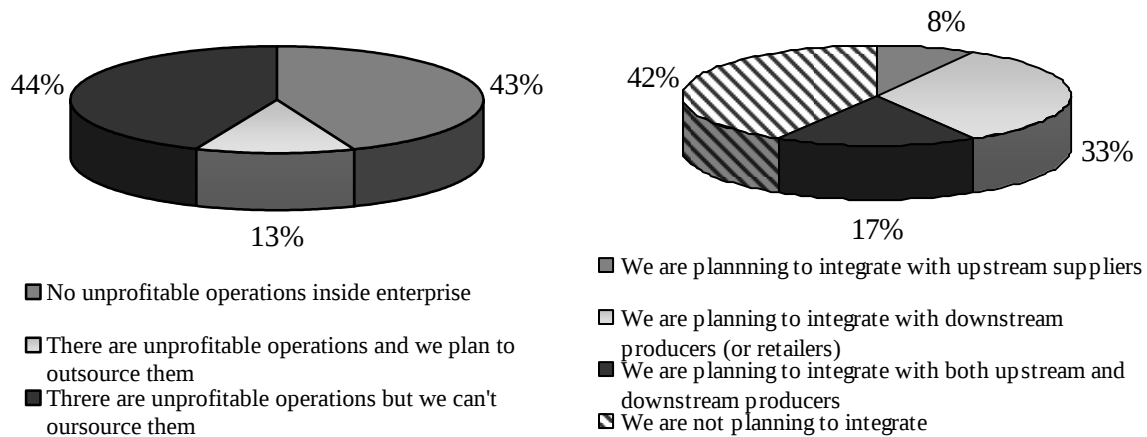
In order to discuss how the governance within value chains influences on the incentives and abilities of furniture producers to upgrade, we have first to present which directions of improvement managers feel necessary. Two types of questions were posed during the interviews. One was about competitiveness of Russian producers in comparison with the foreign ones, and the other was about the plans of the company to improve competitiveness. Figure 8 presents the answers of different types of respondents to the first question. We can interpret them in such a way that managers feel it necessary to improve the product characteristics, in which domestic producers are least competitive. A number of interesting conclusions can be drawn from the answers. There is difference between furniture producers, not involved in the global value chain, suppliers of global buyers and one-shop retailers. First group assesses their comparative advantages in price, delivery and even design high enough. They feel their problems are in the sphere of standards, certification and especially branding. The suppliers of the global buyer agree that they are good enough in quality, delivery and standards, but they are more unpretentious as far as design is concerned and see they are in serious disadvantage with certification. The retailers' assessments of domestic industry competitive advantages are lower than those of furniture producers almost at every point, exceptions are delivery and standards.

These data let us draw the only simple conclusion. Retailers don't ask producers to comply with standards more than they do now. Retailers are sure that Russian furniture is of poor quality and design. Furniture producers feel that their quality and design are good enough for the (low) prices, but they seem to overestimate their price competitiveness. Both retailers and furniture producers feel branding to be extremely insufficient, and producers are more anxious about that. Suppliers of the global buyer regard design and certification as the most important problem for them.

Now let's look at the plans of furniture producers to improve their business. First of all, the plans about internal structure of companies are interesting. Thought almost all the producers, as we have seen before, seem too diversified and integrated, very few respondents look for

outsourcing and, on the contrary, most of them try to integrate. There are no plans for outsourcing even if respondents feel that inside their companies there are operations which don't bring profit to the company as a whole. On the part of integration, half of the respondents feel necessary to integrate downstream, and one quarter – upstream (figure 9).

Figure 9 Plans to upgrade internal organization by outsourcing (left, 16 respondents) and integration (right, 12 respondents)



As for other plans to improve their competitiveness (the question was put as requiring free answers), half of the respondents felt it necessary to expand the sale of items produced at current prices, one third reported they wanted to move to the segment with higher prices, one third of the respondents said they wanted to develop their own brand name. As for product variety, only one third of the respondents are going to adjust product variety: one company considers it necessary to narrow product variety and others – to expand it.

We can draw a number of conclusions assessing the plans of the companies. First, many companies feel unsatisfied with their positioning inside value chain. It seems understandable because most part of value added is located at the final stages of value chains – marketing, wholesaling and retailing (see figure 2). There are links with plans to develop brand name and to integrate with retailers: of six respondents who are planning downstream expansion, four consider they already have a trade mark known by customers and two intend to develop it. Assessing this profile of upgrading, we have to mention immediately that it is available for a very small portion of 2,5 thousand Russian furniture producers. And even if available, there are no guarantees that it will be successful. Evidence shows that fast growth of integrated company at the beginning of the century is replaced by slowing down. From the conceptual point of view, upgrading inside vertical integrated chain includes high risks. Losses of competitiveness can occur due to the diseconomy on vertical growth, including the decreasing incentives to improve efficiency, coordination failures inside company etc. Modular type of governance should have an advantage of flexibility over vertically integrated one. In Russian context however high risks are connected with governance at the final stage of value chain. Domestic vertically integrated company in the course of restructuring of retailing decreased the number of dealers from 500 in 2002 to 150 in 2004. The immediate cause for that was the *free-rider* (Goldberg, 1984) problem: franchisee retailer tried to sell furniture of unknown enterprises under the company's brand name or at least use the brand name of the company to attract customers while the share of the company's furniture in the whole stock was negligible.

At the same time vertical integration gives a company a chance to participate in the profit accumulated at the final stage of value chain that is in marketing and retailing. Weak development of specialized retailing, on the one hand, and inherited from the Soviet past

integrated and diversified internal organization, on the other, make this type of development attractive.

An alternative way of upgrading is market or modular type of governance. But looking at the directions of upgrading proposed by a furniture producer we should come to an ironic conclusion: it seems that restructuring actions proposed could prevent but not promote competitiveness. If these plans realize, companies will be more integrated and more diversified and their ability to control their costs will decrease. Why are many market participants reluctant to upgrade as a part of modular chain, while they want to become a supplier of the global buyer?

The answer seems to be connected with the distribution of rent within the chain. Incentives for upgrading in value chains under modular and market governance may be even higher (due to higher toughness of competition in perception of furniture production), but resources for upgrading are more scarce, since furniture production is the least profitable link in value chains. The global buyer and especially retailers are not ready to pay to furniture producers rent on quality improvement and brand development. Without upgrading by means of repositioning in the value chain, domestic producers of furniture are forced to pursue upgrading that is almost exclusively aimed at cost minimization.

For domestic furniture producers circumstances become worse because the global buyer today is the only customer for the kind of product it needs (standardized product of a specialized producer). In the market with high competition on the part of supply specialized producer faces the *hold up* or *quasi-rent extraction* (Klein et al., 1978) problem. The price of goods produced using specific assets tends to the second-best level that is quite low for a specialized furniture supplier. Other authors also discover this kind of problem in the network of the global buyer: *“The Russian supplier interviewed explained that the fear of losing existing orders from other clients and the decreasing variety and complexity of products made him cautious about prioritizing Ikea before other clients”* (Tarnovskaya et al., 2005). The results of our interviews show that the situation is even more dramatic: there are no other clients for specialized suppliers without brand name and service facilities.

So many Russian furniture producers are at the crossroads now: following two alternative ways of upgrading potentially they are expected to occupy quite different positions in the value chain. Both are associated with specific gains and specific risks. Trying to upgrade by means of vertical integration, there is an extremely high need for resources and extremely high competition at the final stage, discouraging the investments of newcomers. Upgrading in the framework of modular governance, furniture producers have to concentrate on the stage of value chain with the lowest profit margin and to lose margin that they have as a diversified and vertically integrated companies.

Many market participants did not make their choice yet. That is why vertical integration, diversification and scale of Russian furniture producers remain high enough, and managers of *IKEA* in Russia are reporting that their demand is much greater than the Russian industry can cope with (Tarnovskaya et al., 2005). As for international evidence, success of furniture sector development in former socialist Eastern European countries was driven by outsourcing of MNCs and large retailers, accompanied by the process of production fragmentation (Kaminski, Ng, 2001) and corresponding producers' specialization. To what extent this development path is available for Russia – time will show.

Conclusion: Challenges of enterprises' upgrading in Russian furniture industry

The results of the interview presented in this paper demonstrate the problems Russian domestic furniture producers face with. Almost all of them need restructuring in order to enhance

competitiveness. The managers and owners of enterprises understand that very well. The problem is however, that from the value chain theory's perspective, we cannot speak about the competitiveness out of value chain context. To be competitive, a company should first of all be included in the competitive value chain and then should fit the requirements of governance in specific chain.

Weak specialized domestic retailing and inability of retailers to govern value chain in efficient way make it necessary for furniture producers to choose between two alternative ways of upgrading, i.e. downstream integration and entering into the chain of global specialized retailer IKEA. These two ways imply two opposite directions of restructuring. Following one, it is necessary to diversify, to expand product variety, to turn core business from furniture production to furniture retailing. Following the other, it is necessary to specialize, to narrow product variety, to pay much more attention to product costing, etc. Two alternative ways of upgrading are perfectly substitutable: the same feature of furniture producer is an advantage on the one way and disadvantage on the other one. So, the main question Russian furniture producers have to answer is '*To specialize or not to specialize*'. The choice in favor of specialization is difficult because it would be a little exaggerated to say that in domestic market there is only one specialized retailer which is able to govern value chain efficiently. Recent tendencies of furniture industry development allow to suppose that both ways of development will be presented in Russia.

In its turn, lack of restructuring of market participants influences scale and directions of investments in domestic furniture market. Though Russian market is large today and has all the premises to exhibit high growth rates in the future, up to now significant investments have been made either in the stages of production, which can be included in other value chains (for instance, wooden chipboard and fiberboard production) or in a small number of integrated downstream companies. Enlargement of IKEA is an important exception and it shows that needs for investments are high but payback period is very long. It is remarkable that IKEA reported losses in Russian market during several years.

It is worth noting that the Russian furniture company's problem '*To specialize or not to specialize*' and investor's problem '*To invest or not to invest*' are highly interrelated. For domestic producers specialized on items with rich domestic resources (wooden and board furniture, for instance), or, alternatively, for a domestic vertically integrated company with efficient organization of retailing it would be possible to attract investments. On the other hand, the development of efficient specialized retailing in Russia would make for relatively small furniture companies to choose the way of narrow product specialization.

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Gaining the competitive advantages through the development of production system

Vera Kononova⁹³

Institute for Complex Strategic Studies and Graduate School of Business
Administration, Moscow State University

Abstract

The production system of any enterprise is the factory-level management routines including the workers operations, equipment layout and servicing, inventories maintenance, product development and others. The production system determines the productivity and quality and thus it is considered to be affecting a large part of firm's competitiveness.

For the last decades, the high standards for productivity and quality have been demonstrated by the Toyota production system (TPS). It is known that the experience of Toyota is spreading among the US and EU companies. Now the international competition fosters the similar activities in Russia. The positive experience of successful companies in Asia, US and Europe assures that advanced production system can help to gain and sustain competitive advantages. That is why our main goal was to study the dissemination of such experience in Russia and to estimate the economic efficiency of TPS-based implementations under current economic conditions.

In March 2006 we have carried out the industrial enterprises survey devoted to the practices of production system improvements. The survey covered more than 700 enterprises in machinery construction and other industries and was directly addressed to the top management personnel. It was found out that nearly one third of enterprises surveyed have the experience of TPS-based improvements. The most common management techniques being implemented are total quality management (TQM, applied at 22% enterprises), working place visualization ("5S", 9% enterprises) and inventories management ("kanban", 8% enterprises). The leading industries in this process are machine building industry and metallurgy.

Case-studies of several Russian enterprises allowed to inquire into production system improvements in more detail. One of such examples, the Yaroslavl Diesel Equipment Plant, showed that the re-organization of manufacturing through production centers allowed increasing productivity up to 30%, with implementation costs being paid up quite shortly. The other examples indicate that the economic efficiency of production system improvements, which are usually not capital-intensive, can be very high in case if they are carefully planned and introduced.

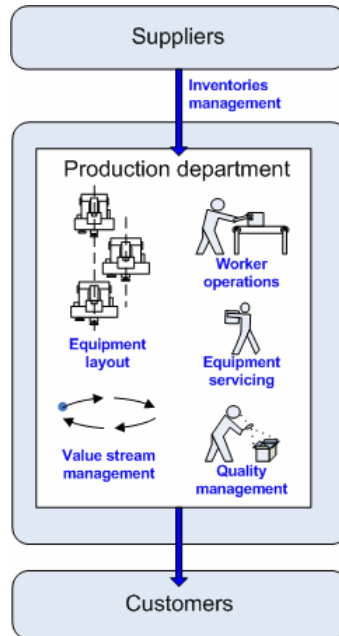
At present time, the opportunities for gaining the competitive advantages by developing the production system are still limited for enterprises in Russia, mostly due to the lack of information concerning the effects of potential production system improvements, and deficit of qualified personnel to manage these improvements. Only 5% of industrial enterprises surveyed have already carried out the large-scale improvement procedures. The possible ways to overcome these problems are introducing specialized professional training at business schools, and facilitating more opportunities for sharing the management experience between companies, with regional or industry focus.

⁹³ Ph.D., e-mail kononova@icss.ac.ru

Production System and its Components

The production system (PS) of industrial enterprise is the factory-level production management including the workers operations, equipment layout and servicing, inventories maintenance, quality management, and other procedures. The main components of production system can be represented as follows (Figure 1).

Figure 1 Basic Components of Production System



The production system embraces all the manufacturing and commercial activities of the enterprise, starting from the purchases of raw materials and ending at shipment of the ready products to customers. Therefore, the production system determines the productivity and quality of production and thus is considered as one of the internal factors of competitiveness.

At present times, the improvements of production system are becoming one of the ways to gain the competitive advantages for the enterprises. The international practical experience for such improvements consists of a variety of managerial techniques, aimed at excluding the “excess”, or “wasteful” operations and employing the other capital-saving means of increasing the productivity. To evaluate the efficiency of production system in comparison with the similar enterprises, the following indicators can be proposed (Table 1). These indicators can also be used as a comparative evaluation instrument for pointing out which components of a production system need improvement.

Table 1 Efficiency Indicators for Production System

Production system components	Efficiency Indicators
Inventories management	▪ Volume and turnover of inventories ▪ Defect rate, % ▪ Amount of late deliveries, %
Worker operations	▪ Timing of basic and auxiliary labor operations ▪ Quantity and duration of unscheduled idle breaks in work time ▪ Number of improvements suggested by workers
Equipment servicing	▪ Quantity and duration of unscheduled equipment shut-downs ▪ Hours spent on installation, start-up and change-over of equipment
Value stream management	▪ Item travel distance inside the factory (from the beginning of manufacturing till delivery to final customer) ▪ Volume and turnover of unfinished products
Quality management	▪ Defect rate of manufactured goods, % ▪ Amount of late deliveries to customers, % ▪ Defects due to the failures in equipment, worker operations, defective supplies, etc.

The best results in developing production systems are demonstrated by Japanese enterprises⁹⁴, for years having been the world leaders in quality management, productivity and cost effectiveness. This is one of the key reasons why modern production systems are built mostly on Japanese managerial techniques.

“Chasing the Toyota”: Japanese Experience of Production Systems outside the Japan

Originally in the USA and Europe the interest to the Japanese production systems appeared in 1970s, after the rapid development of Japanese automotive industry. The fascinating example of Japanese automotive companies has shown that the special managerial methods of organizing the production can make the industry, commonly viewed as the depressive one in 1950s, the top world producer and exporter in 1980s.

The high standards of productivity and quality, demonstrated by Toyota and other Japanese companies, were studied from both the theoretical and practical points of view (Ouchi et al (1981), Schonberger (1982), Oliver et al (2002)). As a result, since 1980 the Japanese experience of production system organization have been implemented at some enterprises of USA and Europe. It is known that the Japanese experience is now applied not only at automotive sector, but also at metallurgy, aircraft industry, household equipment production, trade and services and other sectors of an economy⁹⁵.

Since the Japanese methods and techniques for developing the efficient production systems are described in detail in the literature (Womack et al (1990), Ohno (1988)), below we briefly summarize the most popular methods (Table 2).

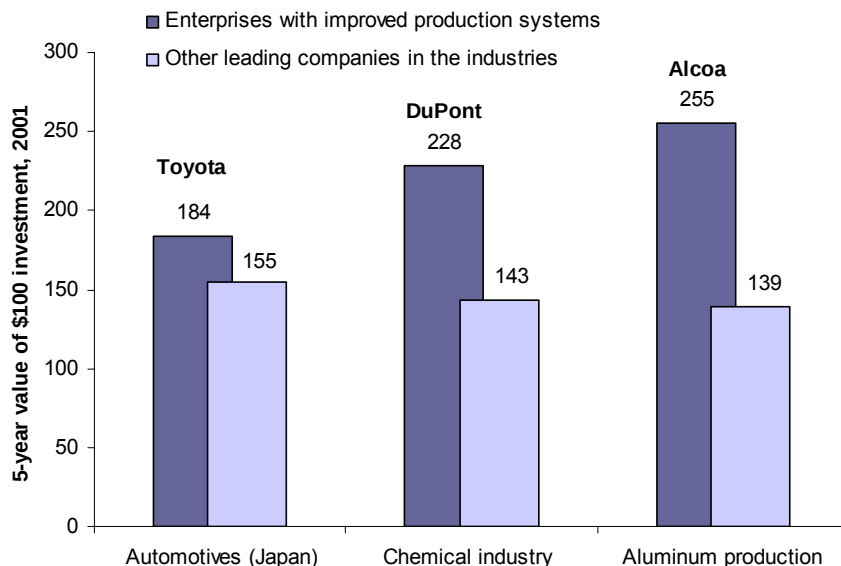
⁹⁴ The complex of managerial techniques applied at Japanese companies is often addressed as Toyota Production System (TPS), Kaizen, Lean Manufacturing, etc.

⁹⁵ The list of companies using Japanese experience of production system improvement includes DaimlerChrysler, Ford, General Motors, DuPont, Alcoa, Bosch, Valeo, etc.

Table 2 Modern Methods of Production System Organization Based on the Japanese Experience

Production system components	Modern organization methods
Inventories management	- Minimizing the inventories by frequent supplies (<i>just-in-time, kanban</i>) - Long-term supplier relations
Worker operations	- Visualization of working place (<i>5S</i>) - Motivating the personnel to make propositions of how to improve the working operations
Equipment servicing	- Enhancing the skills of equipment servicing of the personnel (<i>TPM</i>) - Quick changeover of the operators (<i>SMED</i>)
Value stream management	Optimization of equipment layout and resources transfer during the manufacturing (<i>VSM</i>)
Quality management	- Visual control and automatic prevention of defects (<i>andon, poka-yoke</i>) - Machine-stops in case of problem detection (<i>jidoka</i>)

As a rule, the automotive companies were first to implement the elements of Toyota production system, trying to neutralize the competitive advantages of their Japanese competitors. This process, sometimes called “The Toyota Chase”, allowed the US and European producers to overcome, at least partially, the gap in productivity between Japanese and “western” companies. The advances in productivity allow such companies to have higher investment returns, exceeding the level of returns for the other large companies of the same industries (Figure 2). Nevertheless the automotive sector of Japan still remains the global automotive production leader in inventories management, worker operations, quality management, product development (Oliver et al (2002)).

Figure 2 Value of Investments in the Automotive, Chemicals and Aluminum Industries

The consulting agencies reports and results of analytical investigations show that the development of production system allows the majority of companies to gain the competitive advantages on the market. For instance, the most of them experience the reduction in average production time and decrease in defect rate. A number of companies improving the production systems became the winners of Shingo Prize for Excellence in Manufacturing (which is unofficially called the Nobel prize for manufacturing), Production Plant of the Year, Global Supplier Award.

At the same time, the development of production system does not necessarily entail the advances in productivity and quality. The analysis of unsuccessful cases of improving the production system shows that insufficient attention to the market situation, the reluctance of suppliers and difficulties with financial institutions can be the obstacles, preventing a company from making the production system more effective (Womack et al (1990)).

TPS Dissemination in Russia: the Industrial Enterprises Survey

The development of production systems is the up-to-date problem for Russian enterprises. This is fostered by two main reasons. The first of them is the increasing global competition, which makes the competitive advantages crucial for the market position of Russian enterprises. The second is the budget constraint on investment resources, which limits the opportunities to increase productivity by acquiring new equipment and enlarging the production scale.

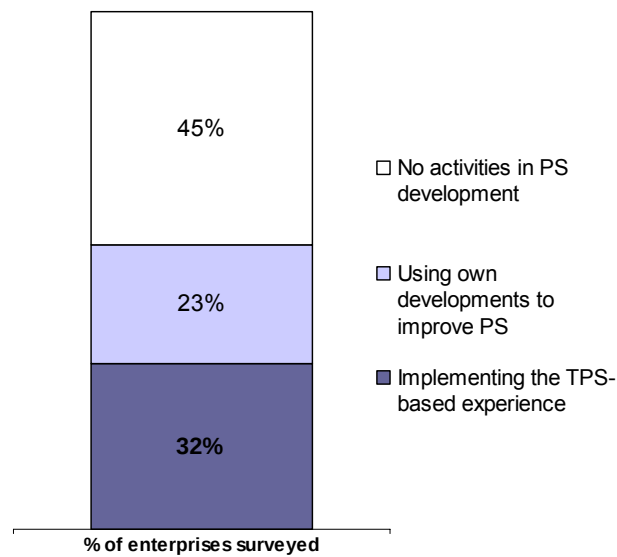
The experience in developing new production systems is now beginning to spread among Russian companies. Several examples of large Russian companies prove that it is one of the prospective ways to make the products competitive. Still there is no information about how widely these managerial techniques are disseminated and whether the results are positive for enterprises. Therefore our main goal was to study the prospects of gaining competitive advantages through developing new production systems in Russia. We began with the industrial enterprises survey devoted to the practices of production system improvements.

The survey carried out in March 2006 covered more than 700 enterprises of various industries and regions of Russia, with emphasis on machinery construction. It was based on the industrial enterprise panel supported by the Institute for the Economy in Transition for conducting monthly surveys by means of harmonized European methodology. The panel follows "one company - one respondent" principle and covers the top management personnel of more than 1000 industrial enterprises from almost all the regions of Russia. 35% of respondents are directors of enterprises, another 35% - vice directors, 22% - heads of economic departments. The majority of respondents (2/3 of the panel) are representatives of middle and large manufacturing companies with 200-2000 employees⁹⁶. Thus, the typical respondent is a relatively large industrial enterprise. The international experience shows that such enterprises have rather good competitive prospects in case of thorough development of production system.

We found out that at present time about one third of industrial enterprises started the activities for improving the production systems. More than 32% enterprises surveyed already have the experience of implementing at least one of the Toyota Production System (TPS) based instruments of production system improvements. The other 23% are improving some elements of their production systems through their own development techniques (Figure 3).

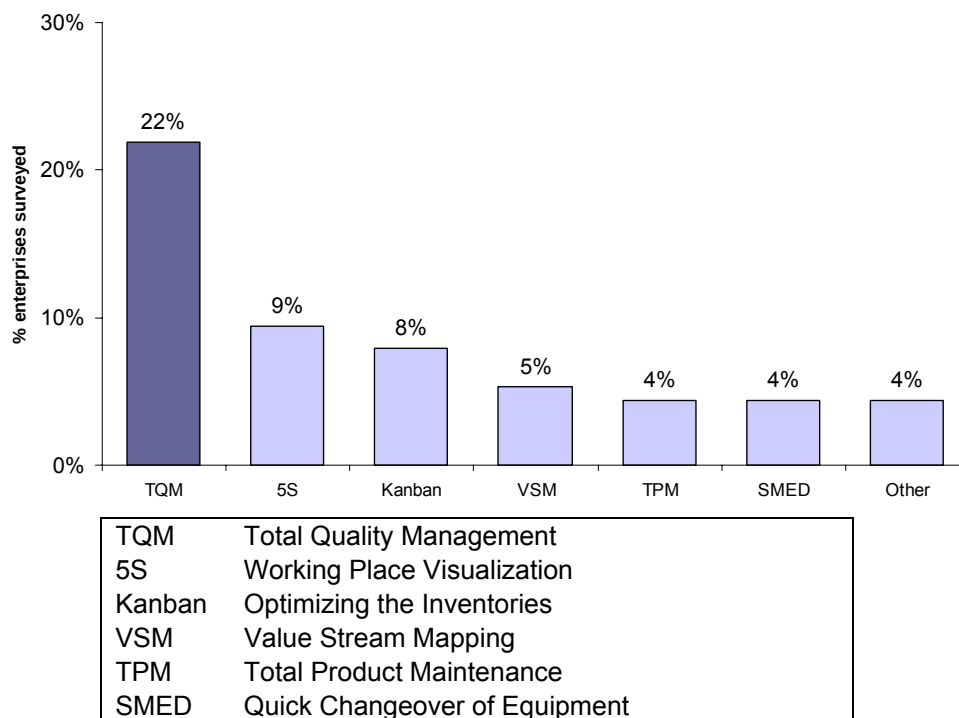
⁹⁶ The majority of enterprises belong to electrical machinery, automotive industry, chemicals and petrochemicals production, electronic industry, ferrous and non-ferrous metallurgy.

Figure 3 Production System Improvement Activities among Russian Enterprises



As a rule, the production system development starts with the introduction of quality management techniques. Total quality management (TQM) is introduced at more than 22% of enterprises using the TPS-based experience. The other popular instruments for PS improvement are working place visualization (“5S”, used at 9% enterprises) and inventories management (“kanban”, 8% enterprises). The other common techniques applied for developing production system are less widespread (Figure 4).

Figure 4 Dissemination of some TPS-based Instruments in Russia

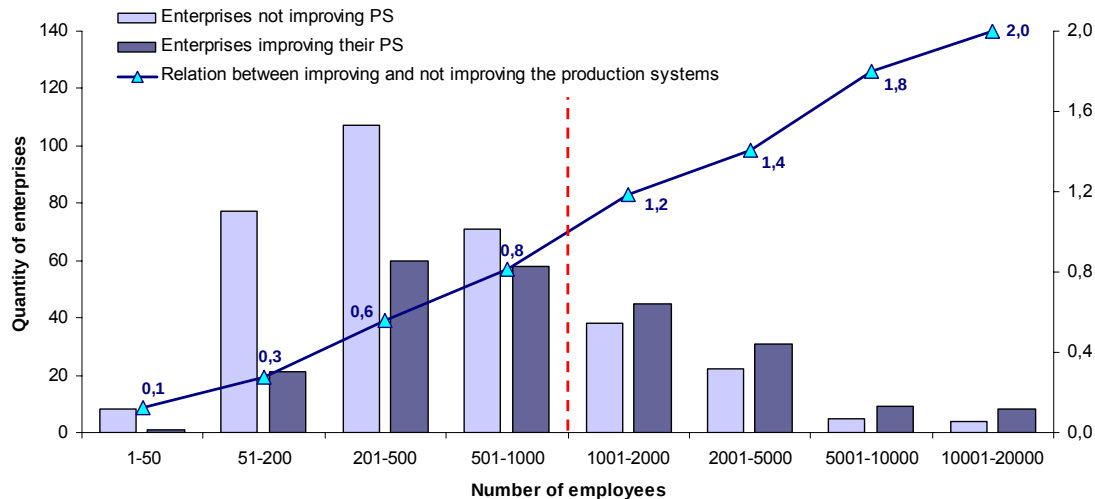


According to the survey, the larger companies in Russia are more active in development the production systems than smaller ones. It can be probably attributed to the better access to information concerning the production system itself, the experience of improving production system and its potential influence on competitiveness. One more probable reason for that is that

the larger companies are more likely to operate not only at Russian market but also in international market and thus might have more concerns for competitiveness.

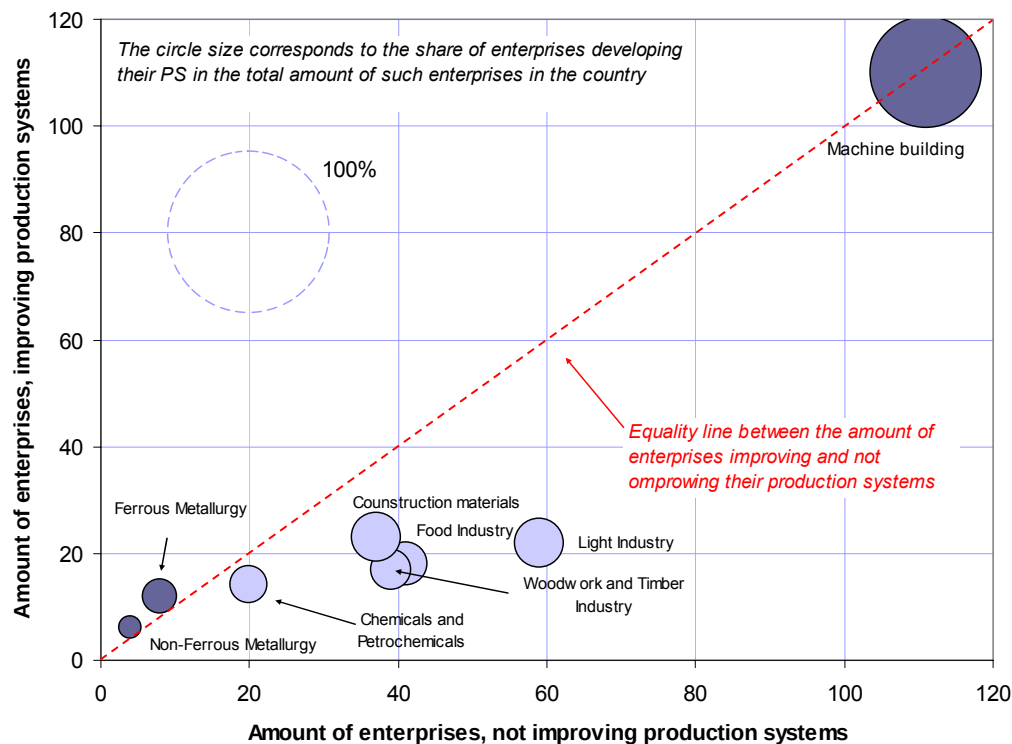
A certain “breaking point” is achieved at the company size of 1000 employees: for the companies of that size or larger the amount of TPS-implementing companies is greater than the “inactive” companies who reported no improvements in their production systems. For the companies having less than 1000 employees, the situation is the opposite (Figure 5).

Figure 5 Dependence between the Size of Enterprises and Activities in Developing Production Systems



The survey demonstrated that the most active industries in Russia in relation to the production systems improvement are the machine building and metallurgy. The simple comparison of the number of enterprises, which are actively developing their production systems, with the “inactive” ones of the same industries, show that only at machine building and metallurgy the amount of “active” enterprises is greater (or at least is equal to) the amount of enterprises which do not carry out the production system improvements. For all the other industries surveyed, the enterprises with no activities in developing the production system still dominate (Figure 6). The probable cause for that is the relatively high level of competition in these industries (including the international competition).

Figure 6 Comparison of Activity in Improving the Production Systems in Various Industries of Russia



Inside the large machine-building complex of industries, the most active in developing the production systems is automotive industry. The automotive companies are among the enterprises which are improving their production systems in the most systematic way. That was the reason to take this industry as an example for further investigations of economic efficiency of TPS-based implementations under current economic conditions in Russia.

TPS Potential in Russia: a Brief Outlook

The competitive advantages potentially offered by improving the production system, were studied in more detail by means of case-studies of several Russian enterprises with the TPS-based management experience. The case studies facilitate a closer look on the development of production system, including the changes in organization structure of the enterprise, training the personnel, step-by-step modifications of production system, and final results of improvements in terms of productivity and cost effectiveness.

One of examples of the systematic improvements of production system, the Yaroslavl Diesel Equipment Plant, showed that the TPS instruments are rather promising for Russian automotive enterprises. For instance, the re-organization of manufacturing through the production centers lead to the 30% or even higher increase in productivity. The improvements on several workshop sections resulted in 3-fold reduction of the factory area used for manufacturing. The economy achieved after the improvements carried out at 16 workshop sections, exceeded 10% of revenue of the enterprise. The costs of the necessary changes were fully paid off within a month.

The improvement of production system can be viewed as a cheaper alternative to the capital-consuming investment. For instance, at the Yaroslavl Diesel Equipment Plant the costs for improvements at one of the workshop sections were 50 times lower than the costs for buying

and installing the new equipment, which could produce the same amount of products with the same quality as it was done after re-allocation and simple upgrade of “old” equipment. Thus, the development of production system can be a substantial internal resource for gaining the competitive advantages not only in Japan and USA, but also in Russia. The case-studies indicate that the economic efficiency of production system improvements can be very high in case if they are carefully planned and introduced.

According to the above mentioned survey, the industrial enterprises which are developing their production systems, are less likely to experience problems with equipment servicing, inventories management and supplier relations. These limitations are weakened or even removed during such developments of production systems as “just-in-time” and TQM. In turn, such “bottlenecks” as worker operations and motivation of personnel are relatively more troublesome for them, compared with the enterprises which do not carry out the improvements in production systems.

It is worth to note that the potential of implementing the TPS-based methods is far from being fully employed at Russian enterprises. Less than 5% of enterprises surveyed have already carried out the large-scale improvement procedures, connected with the systematic improvements in quality management, visualization of working operations, inventories management, “just-in-time” supplies, etc. In fact, the majority of enterprises with TPS-based experience are only starting the long way to the production system development.

The opportunities for gaining the competitive advantages by developing the production system are still limited for many enterprises in Russia, mostly due to the lack of information concerning the potential effects of production system improvements, and deficit of personnel qualified for such kind of improvements. The possible ways to overcome these problems are the professional training of managing personnel at business schools, and facilitating more opportunities for sharing the management experience between companies.

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