



## OECD GLOBAL FORUM ON INTERNATIONAL INVESTMENT

### New Horizons and Policy Challenges for Foreign Direct Investment in the 21<sup>st</sup> Century

26-27 November 2001, Mexico City, Mexico

#### FOREIGN DIRECT INVESTMENT IN ESTONIA: EXPERIENCES AND PERSPECTIVES

##### Introduction

Estonia is considered one of the most advanced transition countries in Central and Eastern Europe. Ever since restoring independence in 1991, reform-minded governments have energetically implemented comprehensive reforms, creating one of the most consistently open-market-oriented economies and favourable investment climates in eastern Europe. As a result, Estonia has attracted among the highest rates of foreign direct investment per capita in the region.

Joannes Mongardini (IMF European II Department):

*“After a decade of independence, Estonia has established itself as a well-functioning market economy and a front runner for accession to the European Union. The cornerstones of its successful transition were the fast privatisation of public enterprises with reliance on strategic investors, a free trade regime, the early creation of a legal framework for private activity, full convertibility for current and capital account transactions, and a transparent policy framework, including the currency board arrangement. These reforms were expedited by the departure of most of old political and economic elite and supported by a strong public determination-represented by newly acquired democratic process-to free the economy from the legacies of Soviet planning” (IMF Survey, 17 September 2001).*

##### Foreign direct investment: stock, annual flows and sectoral breakdown

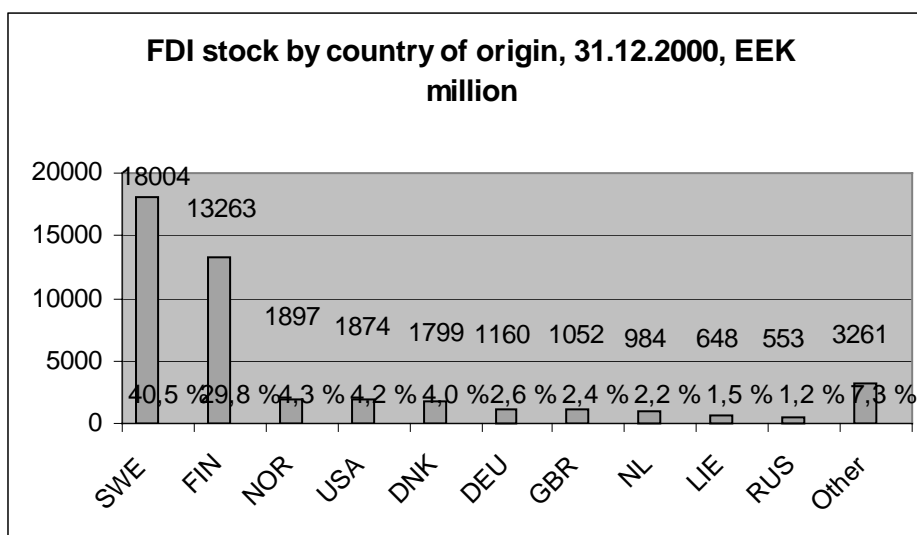
In 2000, total net FDI was estimated at US\$ 277 million, according to preliminary EBRD estimates. This figure is higher than in 1999 (US\$ 222 million), due to acquisitions in the banking sector and a better global investment climate in general. Excluding 1998, when FDI was swelled by the entry onto the Estonian market of two large Swedish banks, the 2000 FDI total is a record high and reflects the favourable business climate.

According to preliminary EBRD estimates, cumulative net FDI inflows from 1993 amounted to US\$ 1.881 billion by the end of 2000. The largest investments have been made in the transport, communications, manufacturing, finance and trade sectors. By the end of 2000, direct investments formed almost half of all foreign investments made in Estonia.

### Countries of origin

At the end of the year 2000, two countries, Sweden and Finland, stood out from the others with their respective shares of 40.5 and 29.8 per cent of the total investment. Altogether, the four Nordic countries account for more than 75 per cent of the total FDI stock in the country, with only the United States joining them in the list of the top five investing countries (Table 1).

**Table 1**



Source: Bank of Estonia; 1 EUR=15.6466 EEK

The strong relative position of Nordic investors in Estonia lasted throughout the 1990s and was even more marked at the end of the period than at the start. Table 2 shows the top 15 investing countries at the end of year 2000. From 1996 to 2000, the positions of the top investing countries stayed more or less the same.

Swedish investment reached a category of its own in the late 1990s, as a result of the consolidation development of the Estonian banking industry. During the period 1998-2000, each year Sweden and Finland were the two main sources of FDI in Estonia. In 1999, for example, they accounted for approximately two-thirds of the total inflow of FDI into the country.

### Sectoral allocation

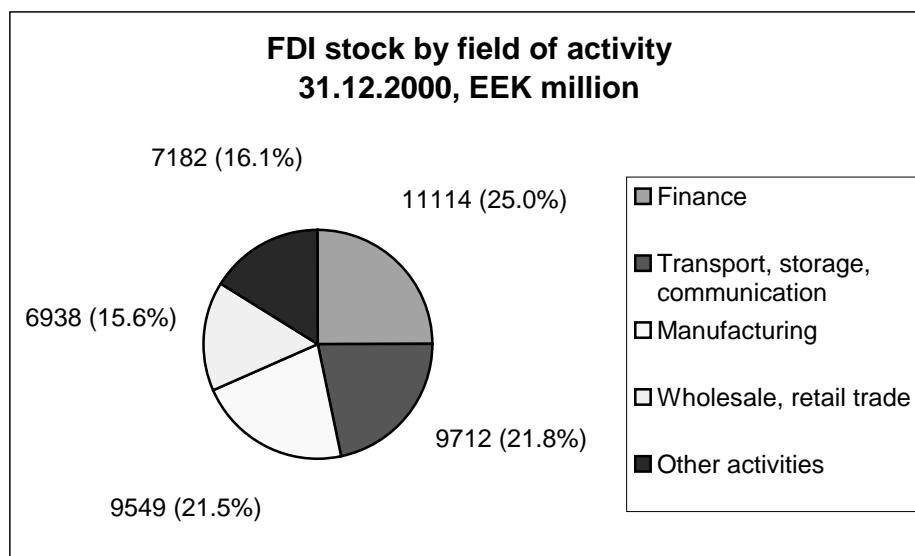
Perhaps the most distinctive feature in the allocation by economic activity of foreign direct investment in Estonia is the top position occupied by financial intermediation. This can be explained by the strong presence of Nordic banks in the local market.

Finance is followed by transport, storage, and communications (including telecommunications), manufacturing, and wholesale and retail trade. The development of FDI in telecommunications has

depended to a considerable extent on privatisation and the investments that followed the liberalisation of the industry.

In 1999, half of the direct investments into Estonia were made into the manufacturing and transport, storage and communications sectors. Investments into finances were also significant. In 2000, finance accounted for approximately a third of the total inflow of EEK 6 807.3 million.

**Table 2**



Source: Bank of Estonia; 1EUR=15.6466 EEK

Among the manufacturing sectors, food and beverages occupy first place, followed by wood, publishing and printing, then textiles and apparel. The high share of "other products" can be explained by FDI into the manufacturing of electronics, which is not classified separately. This sector has recently grown in importance, particularly since the establishment in Estonia of Finnish sub-contractors to the multinational brands in the industry.

### **Government policies affecting FDI environment**

Estonia has considered one of the most favourable investment climates in central and eastern Europe. There is a full legal framework in place for private enterprises, which is largely in conformity with the EU and is being further harmonised with EU legislation.

The development of FDI and indeed the transition towards the market economy, in Estonia, could not have been achieved without an economic strategy that took as its central feature a transparent, fair and open legal regime for foreign investment. Restructuring, privatisation and liberalisation of investment conditions for foreign interests were thus key features of the newly independent Estonia's economic programme. Estonia embarked on substantial institutional and legal reform, aimed at attracting foreign capital by creating a non-discriminatory environment conducive to FDI. These efforts have been widely recognised as successful: in addition to the country's accession to the WTO in November 1999, and its inclusion at the end of 1997 in the first wave of accession preparations to the EU, Estonia has been assessed by various market access reviewers as a generally free and accessible market (see Heritage Foundation "Economic Freedom Index").

## **General principles for FDI**

Until it was repealed on 21 July 2000, the 1991 Foreign Investment Act (as subsequently amended) defined the procedures and legal regime for making foreign investment in Estonia, the basis for investment incentives, and the legal safeguards available. Foreign investors and their investments were granted "equal rights and obligations" unless prescribed otherwise in other legislation (notably in respect to the acquisition and use of land and other national resources). It guaranteed the unhindered transfer of profits, dividends and invested capital and provided fundamental protection and dispute settlement rights (such as in the case of expropriation). These guarantees were secured by the provisions of some 23 bilateral treaties for the promotion and protection of investment, 23 bilateral taxation treaties and adherence to important international conventions. In addition, Estonia established special conditions for making foreign investment in free zones under concessions. However, the Act allowed the Estonian government to "specify areas of activity" where establishment or investment could be prohibited or required a foreign investment license. Investment in banking was also made subject to a license issued by the Bank of Estonia.

Since the repeal of the Act, the framework for business operations is essentially determined by the Commercial Code of 1 September 1995 (other than those defined by a few sectoral legislations described in the following section). As a result, the government can no longer resort to new FDI restrictions. Investment is permitted freely in the form of five business entities: general partnership, limited partnership, private limited company, public limited company and branches. Foreign investors can establish all forms of business entities and own them 100 per cent. Estonia does not prohibit foreign services suppliers from establishing trade offices in any sector and no services sectors or activities are completely closed to foreign companies.

There are no specific tax holidays for foreign investors. Individual income tax and corporate (profit) tax are both charged at a flat rate of 26 per cent.

Certain activities remain subject to an "Activity Licence". There is no longer any prescribed need for foreign investors in certain sectors to apply for a Foreign Investment Licence. Activity licences are granted under the same conditions to Estonian and foreign companies, and are valid up to 5 years. The criteria for these licences are defined by the relevant laws. They essentially relate to health, safety and environmental considerations, national security concerns, or the reliability of basic infrastructure. Anybody fulfilling these criteria can obtain the required licence.

It is necessary to obtain an Activity Licence before entry into the commercial register can be granted. According to Article 521 of the Commercial Code, any undertaking must be registered in the Commercial Register within six months of concluding the Foundation Agreement.

## **Economic Freedom**

Along with enhanced communication "freedom", which is indicated by International Institute for Management Development survey, where Estonia ranks 9<sup>th</sup> in the opportunities for business for electronic commerce, Estonia is also the best ranking transition country in terms of economic freedom, according to the U.S. Heritage Foundation (14<sup>th</sup> in the world Economic Freedom Ranking 2001).

According to the World Competitiveness List, compiled by The International Institute for Management Development, Estonia is 22<sup>nd</sup> in the world in the competitiveness of the market. Within that overall index, different indicators were brought out. For example according to the study Estonia's, Finland's, Austria's and Denmark's exchange rate policies offer the best support for competitiveness of enterprises; in real GDP growth Estonia ranks 11<sup>th</sup>; in Central Government domestic debt Estonia ranks 2<sup>nd</sup>; and in the

Protectionism category (does not prevent foreign products and services from being imported) Estonia is 6<sup>th</sup> on the List.

Transparency International survey 2001 considers Estonia as the least corrupt CEE country and Corruption Perception Index ranks Estonia on the 28<sup>th</sup> position among 91 states surveyed.

### **Main explanatory factors behind FDI**

The motivating factors of foreign investors have been analysed in several studies. In their study based on a detailed dataset that allowed them to identify FDI inflows to a sample of transition economies and the source countries of these inflows, Bevan and Estrin concluded that FDI inflows are significantly influenced by the following factors: risk, unit labour costs, host market size and gravity (distance) factors. In addition, according to their findings, private sector development, industrial development, the government balance, gross reserves and corruption are significant determinants of the perceived country risk (Bevan and Estrin, 2000).

The Estonian Investment Agency and the Faculty of Economics and Business Administration of the University of Tartu carried out four surveys among foreign investors in Estonia during the period 1997-2000 (Varblane 2001). The approximately 100 respondents were divided into four groups according to their field of economic activity, export performance, technological level and employment data. Using the groups distinguished in the literature on foreign investors based, among others, on the theoretical work of Dunning (1994), the largest group (65% of respondents) was characterised as market-seeking investors, the second largest group (18%) as efficiency-seeking investors and the two other groups as natural resources seeking investors (10%) and strategic assets seeking investors (7%).

The findings of the study indicate that market-seeking investors are mainly motivated by entry into the Estonian market and potential market growth. On the other hand, production costs have a strong influence on investment decisions in the case of efficiency and natural resources seeking investors. However, findings show that production costs have increased in significance for all types of investors since the first survey in 1997.

On the other hand, several studies have also been carried out on the investment climate and barriers to FDI as experienced by investors. Two of these studies (Hirvensalo-Hazley, 1998 and Ziazic-Varblane, 2000) conclude that investors are increasingly faced with problems in acquiring skilled and productive employees. The other barriers identified in these studies, such as problems in VAT payments, land purchases, and project financing, are being rectified as legislation and administration procedures improve, together with the rapidly developing banking sector. However, the problem in acquiring highly qualified employees is not as easily corrected as it takes time to train the labour force and, more importantly, change the mentality of those managers who are already in important positions and do not necessarily see the need to re-educate themselves.

Based on the various studies quoted above, most foreign investors in Estonia are market-seeking investors. As the Estonian market, with only 1.4 million consumers, is very small, an increasing number of investors are looking for access to neighbouring EU and Baltic markets. From this point of view, the common trading area and harmonised trade and investment policies around the Baltic Sea region are becoming increasingly important.

Referring to the studies on investment barriers in Estonia, it seems likely that foreign investors have already employed most of the highly skilled potential employees in Estonia and that it is becoming more difficult to recruit a sufficient number of skilled personnel. In addition, the wage and productivity gap that still exists between foreign-owned and local enterprises is beginning to close. This implies in turn that there will be increasing competition for skilled people in Estonia.

Estonia has traditional and newly developed economic sectors: wood and food processing, electronics, chemicals, textiles, energy and engineering, IT, biotechnology, etc. These are industries that have already attracted a fair amount of foreign investment. A crucial issue for Estonia, however, is how to attract new greenfield investments in these and related industries, in order to strengthen the development clusters within the economy.

### **Future perspectives**

The increase in Estonia's foreign debt has been moderate despite its current account deficit, as a large proportion of foreign capital has come into the country as foreign direct investments. Taking this fact into account, the government intends to continue to give equal treatment to foreign and local investors and supports the business environment by favourable tax policy measures and other economic policies.

According to the Ministry of Finance Pre-Accession Economic Programme of April 2001, the essential factor in attracting foreign investments into the country is Estonia's further integration with the EU. Successful integration should improve the legal and institutional framework and provide Estonian enterprises access to European markets.

The amount of FDI in recent years has been influenced by several large single investment projects in privatised infrastructure enterprises. This trend should also carry on for some time to come, since the energy sector is in the process of being both privatised and modernised.

The financing of the current account deficit by FDI shows foreign investor confidence in Estonia. Bank of Estonia assessments indicate that constant FDI inflows require conservative economic policies, and considering the current world economic outlook, consumer saving should acquire a more important role.