Urmas Varblane (ed.)

Foreign Direct Investment in the Estonian Economy

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The first independent Estonian Republic was short-lived (1918-1940) and did not leave any memorable economic exploits behind. In turn, the second independent Estonia Republic (1991) is here to stay and can already boast some major economic successes. Behind Hungary and the Czech Republic and on par with Poland, by 2001 the tiny Estonia had become the third most advanced transition economy (EBRD 2001:14). It is an outstanding performance from a country that shed the shackles of the Soviet Union a little over a decade ago.

In Estonia – and in fact in most countries of the region – foreign direct investment (FDI) has been one of the engines of successful transition. ‘Currently [in 2001] Estonia ranks third after Hungary and the Czech Republic by per capita indicators of the inflow of foreign direct investments,’ states Urmas Varblane in the book’s Preface (p. v). With the exception of Poland – where the per capita FDI stock is lower because of the large population – the rankings in FDI per capita and progress with transition are the same. Sheer coincidence? No. *Foreign Direct Investment in the Estonian Economy* has lots to say in support of why there is a logical link between the two.

In itself it is also outstanding how fast and well a team of leading Estonian experts have prepared this important opus that should be instead be called the “Encyclopaedia of Foreign Direct Investment in Estonia”, rather than the modest title Urmas Varblane and his co-authors chose for this book. In six chapters, they summarise the main findings of the relevant theoretical literature and contrast it with the Estonian experience. Although the literature surveys offer little by way of novelty to the reader already familiar with the standard FDI literature and adopt a very heavy style, it is nevertheless surprising how well the authors have assimilated and applied the huge and complex international literature on FDI. It is also very laudable that, wherever possible, they have tried to keep the data as up to date as possible.

In chapter one, Urmas Varblane provides a panorama of inward and outward FDI in Estonia by industry, country of origin and locational distribution. In other countries, it may have been surprising to see an analysis of outward FDI in a book on inward FDI. But Estonia’s case is somewhat exceptional. A large part of outward FDI is carried out by foreign affiliates. As a result of this indirect outward FDI, the players are almost the same in both inward and outward FDI and the issues to be analysed are linked with each other. This chapter also attempts to forecast FDI flows to Estonia in the future, especially in light of the country’s accession to the European Union. The author’s conclusion is that they are expected to grow, although their composition may change.

In chapter two, Ele Reiljan examines the determinants of FDI in Estonia. The analytical framework (*e.g.* Table 2.3) is largely built on the World Investment Report 1998 (UNCTAD 1998). Still, the chapter is of great value as it presents the results of investor surveys carried out in Estonia and runs a multinomial logistic regression analysis on that data. To a certain degree, counter-intuitively most FDI in Estonia is market-seeking. In such a small economy (1.5 million people), one would have expected the predominance of efficiency-seeking motives. But it turns out that “market-seeking” here means not just the Estonian market but also the other Baltic states and the Russian Federation.

In chapter three, Helena Hannula looks at FDI’s role in economic restructuring. Together with Hungary, Estonia is an example of a country where sales to outsiders (mostly foreign investors) have been the dominant mode of privatisation, resulting in fast and radical restructuring. Curiously, the author claims that Slovakia has been part of the same group, although no specific statistical backing is provided. To the knowledge and reflecting the data collection of this reviewer (see Kalotay and Hunya 2000:41), the Slovak case is in fact closer to the Czech one, dominated by voucher privatisation. Otherwise, the lengthy data analysis carried out in this chapter on Estonian data makes good sense. The only regret the reader may have is that the numbers are somewhat old (1996-1998).

In chapter four, Katrin Männik analyses the role of FDI in technology transfer in Estonia. To do so, the author uses a very detailed data set, which occupies 47 pages of the book, fortunately as an annex to the chapter and not within it. The results are noteworthy as, within the limitations of the analytical tools, Estonia seems to be the only economy in transition so far where a technology spillover can be detected. Why has this not happened in the Czech Republic or Hungary, for example? Are there specific circumstances in Estonia that do not exist in other countries? We suspect that lots of ink will flow (and many Ph.D. dissertations will be written) on this topic until this enigma is resolved. The reader may also miss in this chapter the mention of vertical linkages with transnational corporations. Vertical linkages are important because many phenomena believed to belong to a horizontal spillover turn out to be vertical links once the data sets become more detailed. The most salient example of this is the supplier links found within the automotive industry.

In chapter five, Tiia Vissak analyses FDI’s impact on Estonian exports. Interestingly enough, despite the dominance of market-seeking motives, foreign affiliates turn out to be more export-oriented than local firms. These two items of information are important to keep in mind. They prove that foreign affiliates dominate exports not only because of “cherry picking” (buying only the best enterprises), but because they have better access to international production and distribution networks. What the reader misses in this chapter is an analysis of the trade balance of foreign affiliates. Unfortunately, this issue is mentioned only *en passant*. It would deserve more attention in a subsequent edition of this book.

In chapter six, Ele and Janno Reiljan have the impossible task to analyse FDI in Estonia ‘within the context of economic globalisation and regional integration’ (p. 307). A chapter limited to 27 pages was doomed from the outset to find any new and deep evidence on this extremely amorphous topic. To their credit, the authors attempt to dissect the topic into trade, FDI and other finance components, and provide some overall conclusions. But the reader does not really find any convincing definition of what globalisation really means and how Estonia fits into the broad international picture. It is not sufficiently explained to the reader why the experience of developing countries is so important for Estonia, which is not a developing but a transition country. This question really strikes the reader, especially as the authors over-emphasise the marginalisation of some developing countries and underplay the successful catching up of other countries. Does this mean Estonia risks marginalisation rather than hoping for catching up? Given its economic success, such gloom may not be warranted.

The only key topic not to receive its own chapter in this amazing encyclopaedia is government policies. It is surprising that such a voluminous book supported by European Union (EU) funds simply does not have any policy chapter. Further, there is no in-depth analysis of the impact of the EU association agreement on FDI in Estonia, nor of how the accession talks affect those flows. On the other side of the coin, one would have expected an analysis of how economic relations with the Russian Federation are evolving and influencing FDI flows to Estonia. What the reader finds in the book is indirect references to privatisation policies (already on the very first page of the main text) and an investment climate section in chapter two. The latter, alas, has too much macroeconomic focus and too little on more FDI-related policies.

This lack of a separate policy chapter is a real pity given the unique experience Estonia has had with those policies, distinct from the approaches adopted in the Czech Republic and Hungary. The Czechs and Hungarians undertook rapid import liberalisation and became low-tariff countries by the late-1990s. In turn, the fast import liberalisation resulted in practically overall zero tariffs in Estonia by that time. When Estonia joins the EU it will be required to increase its tariffs – at least as against third parties. These differences in tariff policies with the Czech Republic and Hungary led to differentiated approaches to investment incentives and export-processing schemes. To establish a regime of duty-free equipment and raw material imports for export-oriented activities Hungary and, to a lower extent, the Czech Republic established export-processing zones separated from the rest of the national customs area. In Estonia, there has been less need to do this because imports anyhow became duty-free. In other terms, the zero-tariff element of export-processing is present in the whole Estonian customs territory. What Estonia then needed to make the whole country an export-processing zone was a relatively hassle-free administrative environment for business and relatively good infrastructure. It seems the latter has been more readily available in the capital city where the large majority of inward FDI has so far been concentrated. It is to be noted here that a common element of the Estonian approach to investment location and the Hungarian industrial free trade zones is that, in both cases, it is the investor who chooses the place of investment and not the government by decree. This is a crucial lesson for Central and Eastern European and other countries wishing to attract investors.

Another big difference with the Czech Republic and Hungary is that those countries apply major investment incentives, albeit on a national treatment basis, while Estonia has only limited tax reductions. It would require further analysis to identify the degree to which incentives make a difference for these countries. If Estonia really has attracted large FDI flows and some major projects apparently without any similar incentives, why did the Czech Republic and Hungary need them? Conversely, one can argue whether Estonia would have been even more successful had it also applied similar incentives. This policy question is far from being resolved.

Estonian investment policy has also been different to Czech and Hungarian policies in terms of targeting specific industries and investors. Officially, it was only the Czech and Hungarian investment promotion agencies that picked specific industries, activities, home countries and sometimes even key firms that they have specifically tried to attract. Estonia “just” kept its doors open, without any formal targeting. Still one question haunts the analyst: then, from where does the very strong geographical (Finland, Sweden) and industry concentration (finance, business services) come? Probably we have to introduce a new concept here called “tacit” targeting.

On balance, this is a very important and useful book for both the academia and the business community wishing to know more about FDI in Estonia. This reviewer is also impatiently waiting for subsequent editions that will add not just fresher data but more topics (e.g. policies) and refine the style of this impressive encyclopaedia.

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