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# Foreign Direct Investment in Estonia

Determinants, incentives, trends and strategy

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## Abstract

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### Description

Estonia is a small country in Northern Europe that gained independence from the Soviet Union in 1991. Since then, Estonia has relied heavily on foreign direct investment flows which has had a significant effect on the country's economy, bringing about capital formation, job creation, productivity growth and positive spill overs. The goal of Estonia is to attract high value-added investments; however, the country is facing challenges – poor demographic outlook, labour skills mismatch with demand, rising salaries and external shocks are all deterrent to investment flows.

FDI theory is explored to set the scene – motivations of the firms, modes of investment, determinants and the effects. Estonian economy is analyzed to find strengths and weaknesses as well as looking at determinants that drive or discourage FDI flows to Estonia. Further research is conducted to analyze Estonia's FDI strategy including incentives and recent trends that could make Estonia more attractive to foreign investors.

The findings indicated that investors favored Estonia due to the stability of economy, skilled labour, tax system, digitalization, presence of technologies and location. The nearshoring trend and rising reputation as a technologically advanced country have attracted investors to Estonia.

In order to have sustained level of growth in the future, there needs to be a long-term dynamic plan in place and labour situation and infrastructure need to be improved. The plan should have a wider approach and alternative avenues to FDI should be explored. Greentech and focusing on environmentally friendly sustainable solutions is key as well as global trends are moving towards green technologies.

Keywords: foreign direct investment, Estonia, determinants

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## **Glossary**

FDI – foreign direct investment

GVC – global value chain

MNE – multinational enterprise

M&A – mergers and acquisitions

# 1 Introduction

Estonia gained independence from the Soviet Union in 1991 and opened up its economy to foreign direct investment (FDI). FDI is a cross-border investment, where an investor from one country invests in an enterprise in another country, gaining lasting influence and interest over the enterprise. FDI has benefited Estonia greatly and helped to modernize and restructure the economy (Varblane et al, 2020).

The rapid growth of global FDI flows, especially since the 1980s has caused a huge wave of research trying to come up with theories explaining causes and effects of FDI. The global interest has brought about intense competition between countries, especially since the 1990s when the investment climate improved and FDI incentives were becoming widely used. Most of the FDI comes from multinational enterprises (MNE) and is found to be beneficial for host (FDI inflow) and home (FDI outflow) countries. FDI flows comprise of equity capital, reinvested earnings and intra-company loans (Moosa, 2002). The main modes are mergers and acquisitions and greenfield investments – all posing different levels of risks, costs and benefits (Alba et al, 2010).

FDI brings about economic integration, growth, technology and labour development spill overs in addition to capital flows. According to Duran (2019) FDI is crucial for small open economies with declining populations as it brings capital formation, job creation and productivity growth. The goal of Estonia is to attract high value-added investments that would cause most positive effects on the economy. However, Estonia is facing many challenges – labour mismatch with demand, rising salaries and poor demographic outlook could all hinder the growth.

The first part of the research focuses on FDI theory and determinants, what are the motivations that drive companies to make investment decisions. FDI benefits and effects are explored as well as explaining the different modes and ways companies can engage in foreign investment. Key FDI determinants like

market size and growth, labour costs, political stability, institutions and taxation are looked at in depth.

In the second part Estonian economy is analysed through GDP and growth, trade, participation in global value chains, demographics and labour market, main industries and employers and regional differences. This helps to identify Estonia's strengths and weaknesses.

The third part is history of FDI flows into Estonia, as well as composition of these investments and comparison to other Baltic countries. Determinants are looked at and compared to situation in Estonia. To better understand firms' investment decisions to Estonia, recent investments and trends are analysed as well as FDI strategy and incentives. The final part is analysis of all the gathered data, conclusion and recommendations based on the results of the research.

Therefore, the ultimate purpose of this research is to explore determinants of FDI to Estonia and ways the country is trying to attract foreign investments. Furthermore, looking at why companies have chosen Estonia as a destination country as well as giving recommendations how to ensure future growth and continuous benefits from inward FDI.

## **2 FDI theory and determinants**

### **2.1 FDI theory**

Globalisation has brought interest in international business activities – foreign direct investment determinants and motivations of multinational enterprises (MNE) have been widely researched since the 1960s, trying to come up with theories, causes and effects. The 3 main theories were created by S. Hymer, R. Vernon and J. Dunning (Densia, 2010).

Internalization theory was created by Stephen Hymer, who explained that MNE motivations are due to a firm specific competitive advantage, also called an

ownership advantage. For example, a large company would have a financial advantage over others as it can raise capital quicker and in a larger capacity. Other advantages could include – innovational products or services, marketing or cost advantages, which in turn would balance out the risks and costs of internationalization. The assumption is that the host country market needs to be imperfect in order for internationalisation to be successful and the MNE would need to gain a monopolistic position in the market. The decision to internationalise depends on industry factors, region-specific factors and nation specific factors (Buckley and Casson, 1976).

Vernon created the production cycle theory in 1966, the cycle consists of 4 stages – innovation, growth, maturity and decline. Vernon's theory was built on American corporations investing in Western Europe after the World War 2. The MNE's had a technological advantage over other countries that had suffered from war. These companies could export goods surplus to foreign markets. Later as the technology spread and became widely available, local sales needed to be maintained as foreign companies were starting to provide similar products to their markets. This is the stage where lower costs are were sought in terms of production abroad where, for example, the labour costs are lower (Vernon, 1966).

Dunning's eclectic approach of FDI explained 3 specific advantages – ownership, location and internalization advantages. Ownership (O-advantages) are specific to the MNE and bring about competitive advantage over others through production processes, patents, technological knowledge, reputation or management skills. Location advantages (L-advantages) are specific to the host country, for example, lower labour and production costs, exploitation of local natural resources and favourable tax treatments. Internalization (I-advantages) bring about lower transaction costs, maintaining a firms reputation and minimising technology imitation. Host country determines the specific OLI advantages, all depending on whether the country is developed or still developing, the level of industrialisation, market size, presence of technology, infrastructure and whether the market is monopolistic or competitive (Dunning, 2001).

## 2.2 Horizontal and vertical production

Horizontal activity means that there are larger costs in the beginning – setting up a production unit in another country but MNE's can later benefit from saving from variable costs like transport or tariffs on exported products. For high income countries, the multinational activity tends to be horizontally focused on larger markets, for example US MNE's would start production in Europe to get closer to the EU market and avoid tariffs and high costs of exporting. However, there are foreign regulations, tax systems and administration to keep in mind. Costs can be saved then through economies of scale and lower production costs.

Vertical activity means moving a part of the production to a different country or countries. Often the MNE acts as a supplier or distributor. Michael Porter (1985) explains the competitive advantage of the firm by enhancing the value chain which means dividing firms' activities – design, production, marketing and distribution. The theory suggests that there are different input requirements for different stages of production and costs can be lowered when production is split. This often means that the headquarters of a company are in a capital-abundant country and production is located in a labour-abundant country.

The decision between horizontal and vertical FDI depends on many factors like the distance and market size. Most of the FDI tends to be horizontal but vertical production has also become easier due to technological advancement and open trade environment between countries (Shatz and Venables, 2000).

## 2.3 Motivations

There are four types of MNE activity identified by Jack Behrman (1972) – natural resource, market, efficiency and strategic asset seeking. Larger MNE's tend to combine two or more of these activities.

### 2.3.1 Natural resource seekers

The natural resource seekers invest to gain access to resources that are either higher quality, lower price or are unique to host countries. Generally, the output is then exported to developed industrialised countries. The resources can be physical – minerals, metals, agricultural products or fossil fuels. This type of investment is especially popular in Africa. This type of activity requires high levels of capital and is location oriented. Resource seekers can also be after human resources – supplies of cheap and unskilled labour. MNEs from countries with high labour costs tend to move production to lower income countries. Third type of resource seekers are after technological knowledge, management or marketing expertise. For example, MNEs from EU and US are interested in investing in India, South Korea and Taiwan thanks to the low labour costs and highly skilled workers (Dunning and Lundan, 2008).

### 2.3.2 Market seekers

The market seekers tend to invest in a particular country or region to supply goods or services and as a result, costs are saved in terms of transportation and tariffs, which justifies foreign production. This can be beneficial to sustain and protect existing markets as well as exploit and promote new markets. Market is chosen by the size and growth options as well as many other factors like – global strategy of the MNE, trade policy in the host country, adjacent markets, cost reduction, possibility of exploiting economies of scale and host country policy towards FDI (Dunning and Lundan, 2008).

### 2.3.3 Efficiency seekers

Efficiency seeking activities are often additional to resource and market seeking investments, the company can gain economies of scale, scope and spread risk across markets. The intention is to take advantage of factor endowments, cultures, institutions, demand, market structures and economic policies. These seekers tend to be large, diversified and experienced. For example, MNE can

have information, technology and capital value added activities in developed countries and labour and natural resource seeking activities in developing countries (Dunning and Lundan, 2008).

#### 2.3.4 Strategic asset seekers

The fourth type are the strategic asset seekers – these types of MNE's acquire assets of foreign companies to advance their global competitiveness, these can be for example, physical assets or human competences which in turn will bring about ownership advantages or weaken competitors. This is often done through mergers and acquisitions which means the company is not necessarily taking part in everyday activities of running that foreign company but instead improving the global position of the MNE (Dunning and Lundan, 2008).

### **3 FDI effects on the host country**

#### 3.1 Host country benefits of FDI

Based on popular theory, FDI brings about economic growth in the country. Li and Liu (2005) found that there is a strong connection between growth and FDI in developed and developing countries. The amount of positive change depends on the human capital capability and technologies that are present in the receiving country. This is called the absorption effect – meaning that the country needs to have developed institutions, human capital and technological capabilities to reap maximum benefits from FDI.

In addition to capital gains, positive spill overs are associated with FDI. Ramasamy et al (2017) found that there were short- and long-term positive effects on regional productivity from FDI in India, which was further accelerated by highly skilled labour. Szent-Ivanyi & Vigvari (2012) found that there were significant technological spill overs from FDI to Central and Eastern Europe between 2003 to 2007, all of the 4 countries included in the study (the Czech

Republic, Hungary, Poland and Slovakia) benefitted from positive effects on technological improvement.

### 3.2 Modes of FDI and impact on the host country

Some modes of FDI are considered better than others, bringing about more positive effects to receiving countries. Greenfield investments are very sought after, meaning that a new productive unit is created in the host country. Mergers and acquisitions mean that the ownership of an already existing company changes. Harms and Meon (2011) found that Greenfield FDI had a stronger effect on growth in the host country than M&As. This is due to job-creating and value-added potential of greenfield investment in the host country. M&A's are considered cheaper for the MNE as well as quicker in terms of entering the market and improving competitive position. According to theory - large, diversified firms that are not intensely focused on research and development would choose M&A as the mode of FDI. M&A are not as sought after by the receiving countries due to the fact that it might bring about layoffs or non-beneficial activities, which can be seen as a threat on national level. However, these negative effects can be short term and in the long run transfer of technology, employment and re-investment can occur. The FDI flows consist of – equity capital (investor buys shares in a foreign company), intra-company loans (loans between parent company and affiliates) as well as reinvested earnings (investor reinvests in the host country) (Moosa, 2002).

### 3.3 Criticism of FDI

Even though positive effects from FDI are profound, many researchers have challenged the significance. Hanson (2001) found that there are weak linkages between positive spill overs and FDI to host countries. It is often argued that FDI will in turn make local firms more productive and competitive, but Hanson did not find any evidence supporting that claim. In manufacturing sector, domestic firms had lower productivity growth. In addition, wage spill overs were not as significant either. In a developed country context, MNE's often hire highly

educated and skilled workers whose salaries are higher in any case and do not have an overall effect on the wage level. As MNE's exploit economies of scale and higher capital availability, often domestic companies are unable to compete, and this causes the crowding out effect (Lipsey, 2002).

Herzer and Klasen (2008) did not find any long-term effects from FDI to GDP. There are too many factors and countries differ significantly and whether the country benefits from FDI depends on a mixture of different factors like sectors, policies, institutions and regulations. FDI is not a one size fits all solution for all countries.

## **4 FDI determinants**

### **4.1 The market**

The highest determinant of FDI inflows tend to be the market size, which is measured by GDP, the higher the country's GDP the larger the FDI share. This is supported by Shamsuddin (1994) who found that the most important factor that MNEs consider when making investment decisions is GDP per capita. This is further supported by Resmini (2000) who found that investors prefer larger markets with favourable growth options. Kleinert (2009) states that FDI flows to large markets. In addition, investors often consider neighbouring markets as well as markets that are easier to reach from the host country. Moreover, growth options of the market as well as the size can encourage more FDI. For example, China has been receiving record levels of investment due to the size and rapid growth of the market. Historically, most of the FDI has flowed between OECD countries. The MNEs tend to invest abroad to produce abroad and serve foreign markets, instead of exporting from home country, which reduces costs on transportation and tariffs. These costs can be identified as distance costs. The sales in the foreign market depend on the market size. Therefore, market size as well as distance from other markets and host country are all important determinants in investment decision. In addition to all these factors, market access is also significant, however, future growth possibilities

can outweigh market access issues. On the other hand, areas like the EU market and NAFTA – offering trade freedom and low restrictions, are highly attractive to investors.

## 4.2 Labour costs

Lansbury et al (1996) found that FDI flows to Hungary, Poland and Czech Republic were heavily influenced by low labour costs and played a major role in location decision making process, especially when the labour was skilled. This is supported by Bellak et al (2008) – in the European perspective, low labour costs are important determinants of FDI as well as productivity. Higher labour costs were seen as a deterrent to FDI. This is further supported by Abdullah et al (2013) – low labour costs encourage investors to make the investment decision, especially those who are keen on reducing operational costs.

## 4.3 Political stability

Political stability in a country is often mentioned as a determining factor when firms consider making investments. This is due to the adverse impact stemming from country's environment on possible MNE cash flows. When the risks become too high, the MNE would need to divest. The possible political risks could manifest as – restriction of entry, government intervention (regulating monopolies, price controls, prices for natural resource exploitation), social instability (weak political structures, corruption), systems barring FDI flows (high taxes, weak incentives, equity limits, bans on certain industries), political violence (crime, war, riots), turbulent relations with foreign countries or investors and limits on foreign exchange transfers (Moosa, 2002).

Kurecic and Kokotovic (2017) found that larger developed countries tend to bring in FDI even if there is political turmoil, investors are willing to take the risk and consider the ease of investment more important. For example, FDI flows to Russia and Mexico were unaffected even though both countries faced political risks.

Another great example of this is China - the global leader in inward FDI. Even though the tensions have been high with trade as well as presence of political uncertainty, many U.S and EU companies decide to invest and stay in China due to the future growth of a massive market (Bloomberg, 2020).

#### 4.4 Institutions

Institutions are formal or informal constraints that can include laws, property rights or customs, codes of conduct or traditions. These have a profound impact on the “rules” in human interactions where enforcement of these institutions is crucial (North, 1991). It is assumed that organizations behave similarly in an economy, due to isomorphism – the pressures from environment make everyone adopt the same norms and professional standards. Organizations tend to copy behaviours of other firms. Coercive isomorphism comes from both formal and informal pressures in society. These can include accounting standards, regulations and pollution control laws. This pressure ensures that organisations in the environment behave in a manner that is consistent with others (DiMaggio et al, 1983). Well-functioning institutions can encourage capital flows, because institutions provide confidence to the investors that the risks are low. Institutions and economic structures are especially important in the European context, meaning that FDI flows are very sensitive to institutional problems, especially political institutions. Low level of corruption, fair judicial system as well as property rights, fiscal policy, government spending, labour and business regulations, monetary and trade policies are factors considered by investors when making an investment decision (Dellis et al, 2017).

Sabir et al (2019) found that institutional quality is crucial and impacts FDI flows especially in developed country context. Institutions are as important as macroeconomic variables – profit possibilities are greater in larger markets, however, if there is a high level of corruption, there is a possibility of expropriation. Expropriation is the situation where the host country government would seize properties from a firm.

## 4.5 Taxation

Tax incentives have been found not to be a key determinant of FDI, however, tax incentives are highly popular tool to be used due to the fact that it is much easier to provide these rather than for example improving labour skills and productivity, which would require long term efforts. Tax incentives are easier to offer than funds for investment as government spending is not required. Investors tend to value stability, transparency and simplicity of the tax system over favourable tax incentives. However, if a country has favourable tax incentives, it might convince investors to re-invest which is an important part of investment flows. Therefore, having a transparent, stable tax system is an important determinant to consider when trying to attract FDI (OECD, 2008). Tax incentives have been proven not to be beneficial, if the other factors present in the country do not support investment. For example, when Siemens invested in the U.S. it soon realised that they could not fill the necessary job positions due to a skills gap in the labour market (White, 2019). Therefore, assumption can be made that tax incentives are an additional perk, not the main reason to invest.

## 5 Estonian economy

Estonia regained independence from the Soviet Union in 1991 after 51 years and since then a small, closed economy has become an open, middle-income country, which has greatly benefitted from the membership of EU, free trade and attraction of FDI.

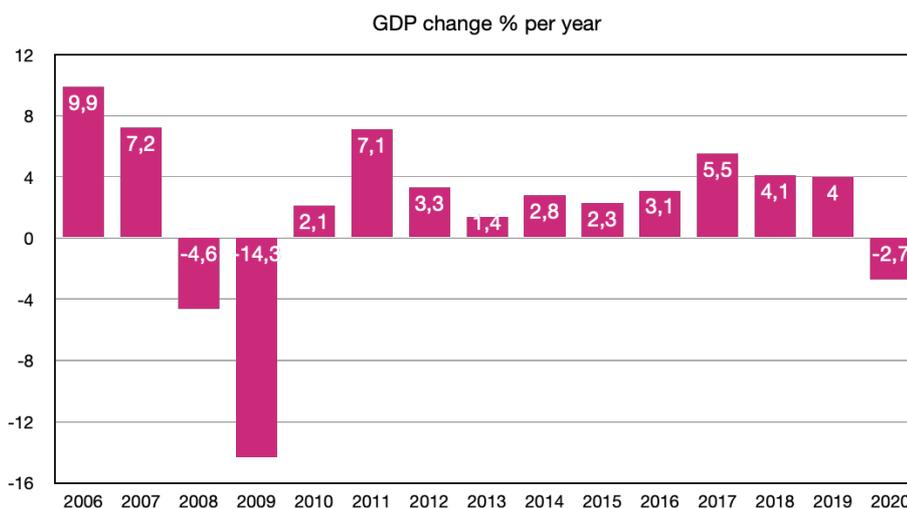


Figure 1. Estonia's GDP growth/decline in percentages, 2006-2020. Eesti Pank Statistics.

The figure above shows the GDP growth and decline between the years 2006-2020. As a small economy, Estonia is very vulnerable to external shocks which can be seen by sudden decrease in GDP during the 2008-2009 Great Recession and again in 2020 during the COVID-19 pandemic. On the other hand, GDP has been growing steadily throughout the years, especially fast growth was seen in the years before 2008. Overall, the country has done well and GDP has grown from 13.5 billion in 2006 to 26.8 billion in 2020 (Eesti Pank, 2021).

### 5.1 Trade

Estonia is in a trade deficit, meaning that the level of imports is larger than the level of exports. Estonia exports to Finland, Sweden, Latvia, Russia and the U.S, while biggest importers are Russia, Germany, Finland, Lithuania and

Latvia (OECD World, 2020). Trade made up 141% of the GDP while exports made up 65.5% of the GDP in 2020, Estonia is affected by the trade trends of the EU as well as recent protectionist trends. In order to better compete, the country should focus more on technology intensive and innovative goods and services as due to the small size of the country, it is impossible to compete in labour intensive goods production.

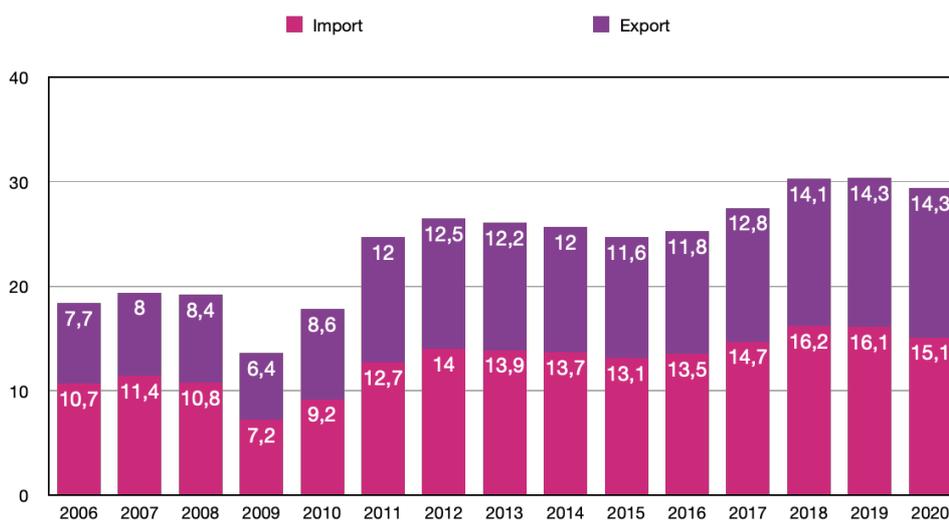


Figure 2: Trade Balance 2006-2020. Exports and imports in billions €, Eesti Pank Statistics.

Participation in the global value chains (GVC) is an important indicator of participation in the global economy. Over half of the global trade can be classified into GVCs, the growth being fuelled by technological advancement, access to markets and resources as well as costs and trade policies. Around 69% of Estonia's exports are intermediates and the country is an active participant in GVCs. The benefits from GVC could improve if Estonia focused more on value creation and value capturing activities like supporting research and development and owning intellectual property (Ali-Yrkkö et al, 2017).

## 5.2 Demographics and the labour market

The population of Estonia is 1.3 million and is aging like in many other European countries. The unemployment rate is relatively low, staying around 6% in recent years. The workers skill base in Estonia does not match the labour

market demands. Foreign investors have identified the scarcity of adequately trained labour as one of the main negative impacts on economic growth. Ministry of Education and Research (2015) found that over one third of Estonian workers are overqualified, making the surplus one of the largest when comparing to other countries in the study. That means many employees are not getting to use their potential to the fullest in the workplace and could do the same jobs without the qualifications. This is especially prevalent among older population, however, since the education was received a while ago, it might not be up to nowadays standards that employers would require. The education requirements set by employers are rather too high and should focus more on actual skills required (Ministry of Education and Research, 2015).

The salaries have been steadily increasing in Estonia, for the past 10 years average wages have risen 6% per year. There is a surplus of manufacturing skills, and more and more manufacturers are leaving Estonia due to high costs which means learning new skills is utmost important for workers to stay active in the job market.

### 5.3 Main industries and employers

71% of GDP comes from the service sector, 25% from industrial and 4% from the primary sector. The largest companies by revenue and employee counts are grocers Maxima, Selver and Rimi, banking group Swedbank, energy provider Eesti Energia, telecommunications service provider Telia, telecommunications equipment manufacturer Ericsson Eesti and passenger transport services provider Tallink (Eesti Maksu ja Tolliamet, 2021). Only 3 of these are domestic firms – Selver, Eesti Energia and Tallink. Maxima is a Lithuanian company, while Rimi, Swedbank, Telia and Ericsson are all Swedish owned.

### 5.4 Regional differences

Estonia is working hard to reduce regional differences – bigger cities like Tallinn and Tartu are constantly growing and contributing the most in terms of

economic growth and job opportunities. The North (Harju municipality) and South of Estonia (Tartu municipality) where these cities are located are seeing larger amounts of skilled workers, active companies and growing populations, meanwhile East of Estonia (Ida-Viru municipality) is falling behind. 40% of the population lives in Harju maakond. Regional policy set in place tries to even out the differences (Siseministeerium, 2021).



Figure 3. Map of Estonia, Geoportal Republic of Estonia Land Board.

## 5.5 Strengths and weaknesses

One of the biggest strengths of Estonia is the favourable business environment. According to the 2020 Index of Economic Freedom, Estonia takes the 8<sup>th</sup> position in the world. The property rights as well as government integrity are very highly ranked. Monetary and business freedom are high, the framework is well regulated and transparent. Investment, trade and financial freedom are considered very high, government policies do not interfere with FDI flows (The Heritage Foundation, 2020).

The government budget is well balanced and foreign debt levels are kept low, which creates a stable environment. Economic policy favours growth – increasing productivity and competitiveness are the key goals. Innovation and focus on high-value added sectors like IT and engineering as well as digitalisation is highly favoured.

The geographical location also benefits Estonia greatly as well as being a member of international organisations. As a small economy, joining EU has brought along great benefits. Estonia is often described as the connection between the East and West as well as being close to other Nordic countries is seen as a benefit.

The biggest weakness is the small market size, which is very prone to external shocks, however, as seen from the Great Recession and COVID-19 pandemic, Estonia is able to recover quite quickly. In 2021, economy has grown 12.9% compared to 2020. The demand for goods and services has risen due to rising salaries, release of pension funds and using savings, which has also raised the prices. The quick escalation of prices can be explained through issues in the supply chain with imports, surging energy prices and manufacturers being unable to answer the rising demand (Kattai et al, 2021).

One of the biggest threats to sustainable growth of the country is the poor demographic outlook which will cause labour shortages. The population is small, birth and immigration rates are low and the population is aging. The working age population is decreasing every year (EIU ViewsWire, 2021).

The problem which is present in all developed nations – rising inequality is also prevalent in Estonia. This has also caused political turmoil like in many other countries – the popularity of the radical right wing party EKRE has been soaring. This was mentioned by the prime minister Kaja Kallas in the interview given to FDI Intelligence, how the far-right party has ruined the reputation of Estonia as a country who does not welcome foreign investors and talent (Miles, 2021). Statements and actions by radical parties can deter investments and growth.

## 5.6 Future outlook

During the global COVID-19 pandemic that started in 2020, Estonia's economy has not suffered significantly and is in better shape than many other EU countries (EIU ViewsWire, 2021). Estonian economy has grown 12% in 2021 compared to 2020, however some industries are still under the strain of COVID-19 restrictions and consequences of pandemic are hindering the overall growth of the economy (Oja, 2021). Recently with the introduction of vaccination passports, many service and hospitality establishments have been able to remain open. The government tries not to introduce another lockdown which would cause further harm to these sectors. The overall predicted growth of economy is around 5-8% for 2022 (Eesti Pank, 2021).

Household spending has increased, due to people using savings and the release of the mandatory second pillar pension saving funds. This year the government made this fund optional – people can decide to withdraw the savings. Consequently, 1.3 billion was withdrawn from the banks, meaning that it will boost the economy by household spending in the short term, depending on the amount of people who decide to spend rather than re-invest. However, using savings on such a large scale could overheat the economy, making the growth unsustainable (Eesti Pank, 2021). OECD suggested that this should not have been allowed as it created macroeconomic instability and pension inadequacy (OECD Economic Survey of Estonia, 2019).

The job market has seen an increase of job offers and is again suffering from labour shortages, the unemployment rate is expected to return to 5% in 2022. Due to rising salaries and withdrawal of savings – the housing market is booming once again and is very active. Estonian Central Bank is considering strengthening the mortgage loan conditions to avoid similar consequences as from the 2008-2009 financial crisis housing market crash (Eesti Pank, 2021).

## 6 Research methodology

All information concerning foreign direct investment – determinants, modes, motivations and effects will be explored through theoretical framework.

Empirical analysis is conducted to explore the reasons why certain companies have invested in Estonia. The case study method is in-depth research for a particular topic or phenomenon with a real-life setting – which leads to development of a theory. This method is the best to understand what and why something is happening, drawing from qualitative and quantitative data from a wide range of sources (Saunders et al, 2019).

Secondary data sources are both qualitative and quantitative – a wide array of previous studies done as well as books, journals, articles, reports and statistical information.

FDI has been very widely researched in the previous decades which can prove difficult in navigating and understanding which sources are objective and reliable. On the other hand, specific research concerning Estonia is not as widely available and is often outdated, therefore it is important to make sure sources are still relevant. Furthermore, subjectivity should be considered when using sources where the goal is to attract FDI to Estonia – these research papers could emphasise the positives and downplay the negative sides.

Research validity measures to which extent the data collection accurately measures what it intends to measure as well as the findings being in line with what was researched. Validity can be confirmed through triangulation, meaning that multiple independent sources are used and similarities in results analysed (Saunders et al, 2019).

## 7 Findings

### 7.1 History of FDI

FDI has played a crucial role in the past 30 years transforming Estonia from a centrally planned economy to a free-market economy. Estonia regained independence from the Soviet Union in 1991, the FDI flows immediately surged due to wave of privatisation and low labour costs (Duran, 2019). In the 1990s the “shock therapy approach” was used which meant privatisation, fiscal policy to reduce budget deficits, lowering government intervention and price liberation. Kroon, the Estonia’s own currency was established in 1992, which was pegged to the German mark. The economy suffered from high levels of inflation and losing the biggest trading partner – the Soviet Union. By 1998, the inflation rate stabilised. In the beginning Estonia mostly focused on manufacturing, by 1999 the country became more service based – transportation, retail, wholesale and real estate were the largest sectors. Estonia was attractive as an FDI receiver due to skilled labour, low wages and undervaluation of Kroon (Weikert, 2018).

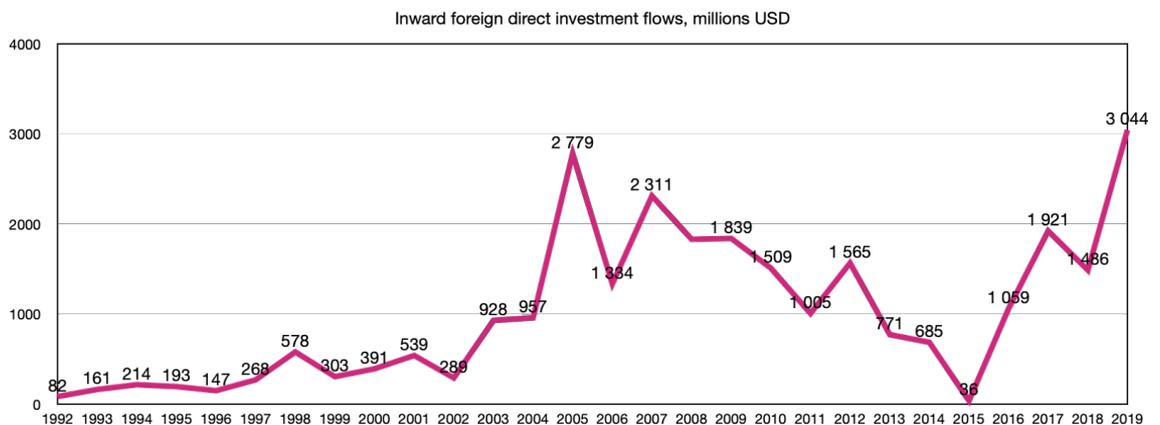


Figure 4. Inward foreign direct investment flows to Estonia, UNCTAD statistics.

FDI to Estonia surged again when joining the European union in 2004 and in 2005 Estonia’s Hansapank was taken over by Swedish Swedbank. In 2006 reinvested profits raised significantly and greenfield investments decreased. The FDI flows saw a drop during the Great Recession of 2008-09 and positive trend was seen again in 2016 (Varblane, 2020).

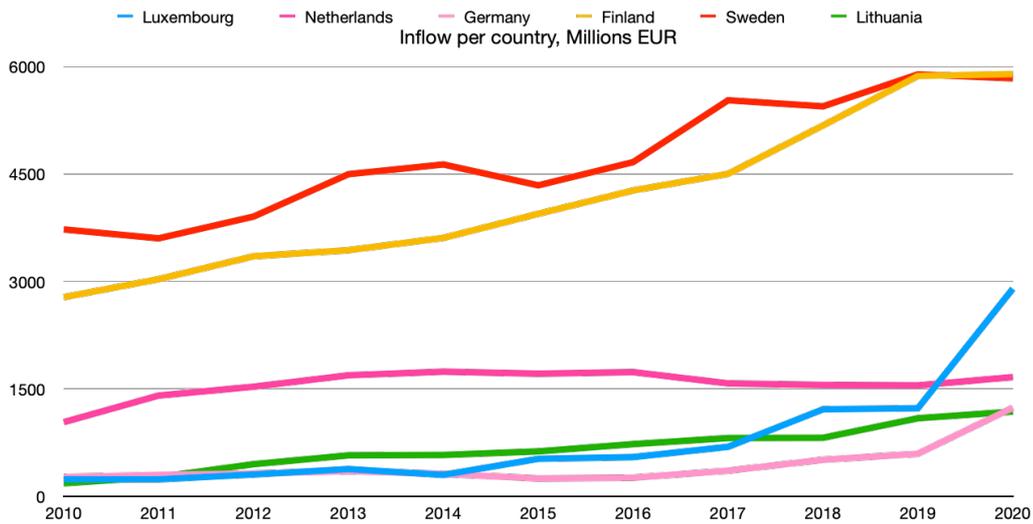


Figure 5. Inflow of foreign direct investment by country, Eesti Pank Statistics.

The largest investors to Estonia have always been Sweden and Finland, other largest investors in the last decade have been the Netherlands, Lithuania and in recent years Luxembourg and Germany.

## 7.2 Composition of investment inflows to Estonia

The financial sector brings in the largest amount of FDI to Estonia, followed by real estate, manufacturing and wholesale and retail. Science and engineering have been growing in the recent years as well as information and communication. Investment flows to agriculture are relatively low. The high number of investments to the financial sector can be explained by the fact that the biggest banks in Estonia have been acquired by foreign companies.

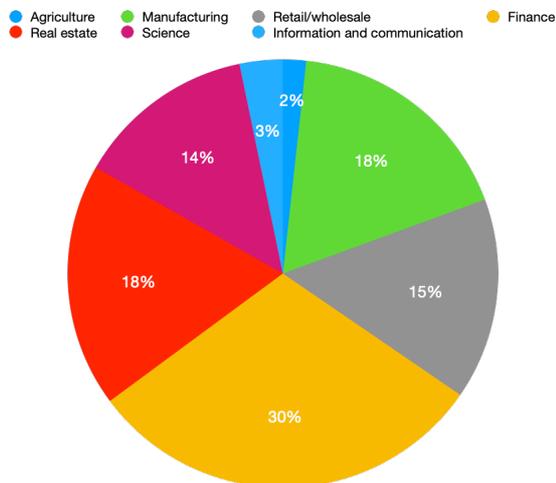


Figure 6. Direct investment position in Estonia by field of activity, Eesti Pank Statistics.

Historically most of the investments to Estonia were low value added – in recent years greenfield investments made up only 18% the overall FDI flows. However, surprisingly during the COVID-10 pandemic, Estonia managed to rise to the 5<sup>th</sup> position in the world in Greenfield Performance index 2021 (McGarrity, 2021).

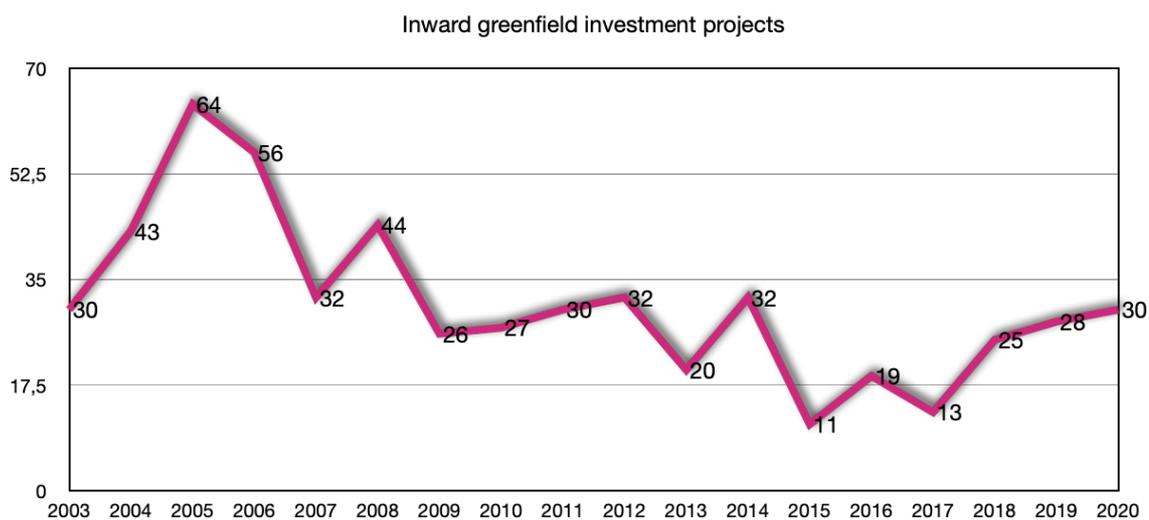


Figure 7. Greenfield projects in Estonia 2003-2020, UNCTAD statistics.

The number of greenfield investments has risen in recent years since hitting an all-time low in 2015. In order to improve, Estonia would need more specialist and highly skilled workers to meet the needs of investors.

### 7.3 Comparison to other Baltic countries

Comparing Estonia to Baltic neighbouring countries is appropriate due to historical similarities. However, Lithuania's population is 2.7 and Latvia's is 1.9 compared to only 1.3 million habitants in Estonia. Since the decline in 2015, Estonia has been gaining momentum and has reached higher inflows than Latvia and Lithuania.

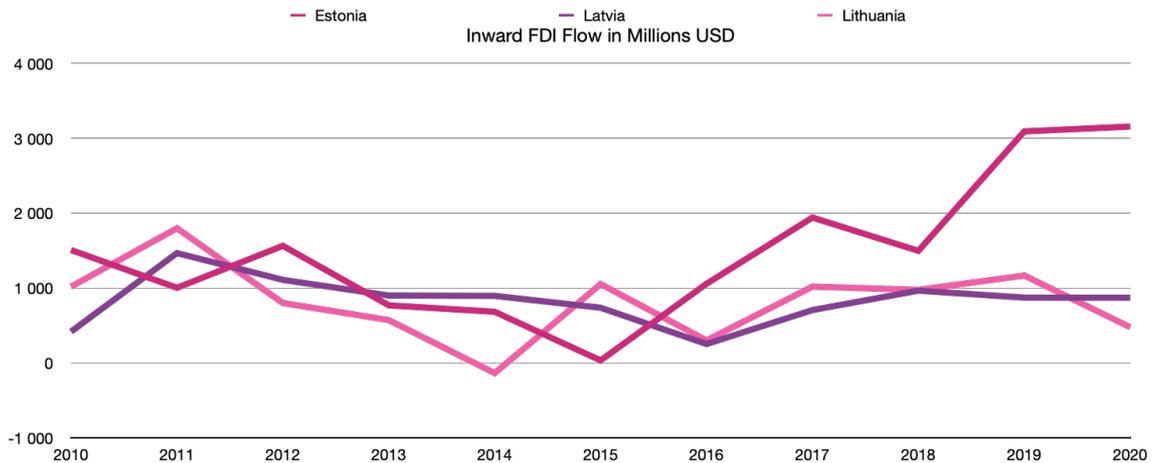


Figure 8. Inward FDI flows to Estonia, Latvia and Lithuania in Millions USD. Eesti Pank Statistics.

## 8 Determinants and motivations

### 8.1 Determinants

Shamsuddin (1994), Resmini (2000) and Kleinert (2009) agree that the highest determinant of FDI inflows is the market size, which is measured by GDP. Investors tend to favour large markets with probable growth options. Market access is also considered an important factor. GDP includes private and government spending, investments and net exports. Estonian population is only 1.3 million people: it is considered a small market, therefore by this determinant, Estonia should not be as attractive as it is one of the smallest markets in Europe. However, since the country belongs to EU, ease of access to other nearby markets is a considerable factor for investors.

Lansbury et al (1996), Bellak et al (2008) and Abdullah et al (2013) all found that labour costs are an important determinant of when making investment decisions, especially when it comes to production. MNE's tend to prefer countries with highly skilled labour and low costs. Estonia is facing a difficult situation, falling into the middle-income trap, meaning that large corporations are not finding Estonia attractive due to rising labour costs and suffering profit margins (Duran, 2019). Furthermore, the lack of skilled and unskilled workers

means Estonia is unable to attract and compete with larger European populations (World Bank, 2020).

This can be seen in the trend of moving production away from Estonia. Most recently, the global company ABB decided to close its production facilities due to rising costs and is planning to open the unit somewhere else in Europe (Pärli, 2021). Another example is PKC group – the company closed its production units and moved them to Lithuania and Russia, where the labour market is larger, and the costs are lower. This was a huge loss to the country as the company was one of the biggest exporters in Estonia (Tubalkain, 2016).

Estonia is considered a politically stable nation, however, there are many challenges and threats the country faces. Estonia has a multiparty system and these have proven to be unstable in the past, worryingly Conservative People's Party Of Estonia has gained popularity in the recent years which could mean that international relations could suffer due to this party being very anti-EU and foreigners. Estonia has a good relationship with its neighboring countries, however, tensions with Russia remain high. Since being a former member of the Soviet Union, Estonians feel very passionate about the situation in Ukraine and Belarus, it can be assumed that Estonia would support further sanctions set against Russia by the EU (EIU ViewsWire, 2021).

Institutions are a crucial determinant of receiving FDI inflows meaning the rule of law, regulatory efficiency and openness all must be favorable. Estonia's government integrity is very high – property rights and contracts are respected and expropriation is not permitted. The judiciary is not affected by politics. There are some issues with corruption however these incidents are rare. The country also has high levels of labour, monetary and business freedom (The Heritage Foundation, 2020).

Estonia's tax system is considered the best in the world for the past 7 years. The International Tax Competitiveness Index by The Heritage Foundation (2020) measures a country's tax system through neutrality and competitiveness. Estonia does not have taxes on reinvested and retained profits and 20% tax

rate for distributed profits. According to Enterprise Estonia, 98% of taxes are declared online and the process is quick and transparent.

## 8.2 Motivations and FDI trends

The investors motivations can be market, strategic asset, natural resource or efficiency seeking. According to a study conducted by Varblane et al (2020) the investors expressed that most important factor when investing in Estonia is the stability of the economy, skilled labour, favourable tax system, developed infrastructure and digital services. The least important factor was natural resources, which Estonia lacks. In the past, motivations to invest in Estonia were more towards efficiency seeking – labour costs and electricity prices were deemed as more important in the questionnaire conducted in 2009 and had significantly lost importance in 2019. Additionally, the importance of technology has risen dramatically from 2009. Investors also mentioned logistical positions as one of the reasons for investing – closeness to other markets in the Baltic States as well as Scandinavian countries. The steady growth of the economy was also mentioned as one of the reasons why investors would choose Estonia.

## 9 Recent investments

### 9.1.1 Nordic countries

Recent notable investment came from Sweden/Finland – MCF Group (81 million) – to build a large data centre in the outskirts of Tallinn, which is considered one of the biggest investments in IT in recent years. This investment will make Estonia more attractive to other companies, since there is a place to safely store their data nearby. The MCF group stated that Estonia is a great “gateway between east and west” and goals were to get closer to Eastern European markets. The attractiveness of the tax system, economic stability and good reputation were also pointed out by the company as one of the reasons for choosing this location (Männi, 2020).

Stora Enso, Finnish manufacturer of pulp, paper and other forestry products has opened a Financial Services Centre in Tallinn. In addition to creating a financial services hub, the company found that it's a great way to evaluate activities and efficiency, finding improvement in their processes – automation and robotics will ensure that people can focus on creative and value-adding analytical tasks (Invest in Estonia, 2019).

The Finnish company Ensto Ensek AS – named the investor of the year 2021 – managed to grow even with the global pandemic and offered 90 extra jobs to Estonian workers – for example from the service sector that was put on hold due to COVID-19. Ensto Ensek is constantly growing meaning that facilities need to increase production volumes – Estonia receives the largest capital flows in Ensto group. Recently the company has invested 2 million euros in silicone production at the Keila factory. The company is interested in automation – robots for transportation as well as environmentally friendly digitalisation – going paperless in the production process. Ensto Ensek explained the interest in Estonia due to highly skilled ambitious workers as well as technological advancement, flexibility and adaptability. Enterprise Estonia is working closely with Ensto group by offering consultancy services, the success story of Ensto Ensek shows that is important to take care of long-term investors as well as new investors (Mäe, 2021).

Recently the Finnish circular economy company Swappie has opened offices in Tallinn. This brought Estonia 200 new jobs which is predicted to double to 400 in the year 2022. This was a good example how even during the pandemic times and economic uncertainty, it is possible to set up a unit in Estonia. Swappie Estonia will focus on automation of their processes so human resources can be best utilised (EAS, 2021).

HANZA, a global manufacturing company, headquartered in Sweden, has invested 8 million euros to their production unit in Estonia. HANZA employs around 650 people in Estonia so far and is planning to open a new facility in Tartu in 2022. The new plant's location is chosen due to logistics and will utilise efficiency and sustainability. The company is considering nearshoring

production to Europe from Asia. The business development unit in Sweden explained that Estonia has many advantages – logistical position and short-decision making as well as the ability to support production with local labour force (Liive, 2021).

### 9.1.2 The Netherlands

One of the top 10 foreign investments of 2020 was from Van Oord, a Dutch maritime contracting company. The plan is to build an offshore wind farm in the Saaremaa region. This would help Estonia reach green energy goals for 2030 as well as creating 200 new jobs in Saaremaa region. Creating a fishing farm is planned as well, currently most of the fish consumed is imported (Lember, 2020).

### 9.1.3 Germany

FDI flows from Germany have surged in the recent years with many companies discovering Estonia as an excellent destination for investment. In 2020, Birkle IT opened offices in Tallinn, the company explained reasons behind choosing Estonia – haven of IT expertise, digitalisation and speed and absence of bureaucracy which is very prevalent and complicated in the German business world (EIA, 2021).

Arvato Financial Solutions has recently expanded their business in Estonia by opening up a new Innovation and Development office in Tallinn, the company focuses on cybersecurity and e-commerce solutions. The company has a very diverse set of employees and finds that the residency and work permit system is very easy and fast – also there is no quota on IT sector for international workers. Arvato has invested in the IT education in Estonia and works with students from TalTech and Tartu universities. The company offers at least double of an average salary as well as growth opportunities on a global level (Hellrand, 2019).

The car manufacturer Volkswagen has opened up two subsidiaries in Estonia which will support VW software business, offer legal support and look after intellectual property. There are already future plans in place to expand which include software development. The presence of self-driving transport developing start-ups like Starship and Cleveron helped spark the interest in the German conglomerate (Liiva, 2020).

Siemens established a Nordic Engineering Center in Estonia, which provides central design and configuration services to other Siemens' offices in the region. The company is also planning to increase the worker base. Siemens explained the investment decision through lower salary levels for engineers and Estonia's reputation as a digital pathfinder (EIA, 2021).

## **10 Recent trends**

In 2020 due to the global pandemic, FDI flows fell 42%, the biggest decline was seen in developed countries, especially in Europe and United States. Asia fared better than other regions with China reaching the 1<sup>st</sup> position in the world. There is no significant growth predicted for 2021. M&As are predicted to be preferred by investors as these pose lower risks than the new greenfield projects. (UNCTAD, 2021)

The largest FDI flows globally to renewable energy sector, real estate, communication, electronic components, software IT services, food and beverages. The world is moving away from fossil fuels, these projects have reduced by 87.3% (O'Farrell, 2021).

### **10.1 Geographical location and nearshoring**

The new global movement of "nearshoring" is bringing production lines back to Scandinavian and Baltic regions as companies are starting to prefer producing nearby, rather than in Asian countries (O'Farrell, 2021). Estonia's geographic location and closeness of culture to Nordic countries like Finland and Sweden is encouraging investors to bring their business to Estonia. For example, the

Swedish company HANZA is considering nearshoring from Asia to Europe due to the pandemic situation as well as sustainability in the long run – the values of supply chains are changing. Manufacturing regionally would reduce costs from transportation as well as the negative effects on the environment (Liive, 2021).

## 10.2 Start-up scene and unicorns

Estonia is really putting effort in chasing unicorns, start-ups reaching billion-dollar valuation, since the 2005 success of Skype, the country has gained 7 total start-ups with unicorn status – making Estonia the world leader in unicorns per capita. These are – Skype, Playtech, Wise, Bolt, Pipedrive, Zego and ID.me. VC investments have also started coming in and placed Estonia the first on VC funding per capita by country. This is a great way for the country to stand out and show others how it is able to produce tech companies – Wise, Skype and Bolt are all mentioned as top 10 tech companies founded in Central and Eastern Europe (EIA, 2021). The active and tech savvy start-up scene in Estonia can encourage FDI as well – as seen from Volkswagen's case where German company was interested in working with local tech companies due to their unique self-driving technologies.

## 10.3 Greentech

The global trends show higher interest in green technologies that are tackling climate change. In order to stay competitive in receiving FDI, countries have to adapt to new technologies and be open to change. Estonia wants to be the front-runner and developer of these innovative changes. The favourable sea-side location as well as wind conditions and infrastructure can support green energy production. (Liive, 2021) Current projects are

- Enefit and Orsted (Danish global leader of offshore wind) are planning to build an offshore wind farm which would be able to cover both Estonia and Latvia energy needs

- Van Oord (The Netherlands) and Saare Wind Energy are developing an offshore wind farm near the island of Saaremaa
- Port of Tallinn is chasing investment to be able to use hydrogen technologies for ferries which would include building a new port terminal to Estonia

Oil shale mining is something Estonia has greatly benefited from in the past, however, this is not a sustainable or environmentally friendly source of energy. Estonia is one of the most carbon intensive economies in the OECD. The move away is going to be difficult as 70% of the country's energy supply comes from burning oil shale. This pollutes groundwater as well as air and soil in the Ida-Virumaa area. However, the area has a higher unemployment rate than the rest of the country, stopping oil shale mining and production would mean the loss of thousands of jobs (OECD, 2017).

#### 10.4 Automation and robotisation

There has been a huge focus on technology in recent years – robots, AI as well as automation. This is one way Estonia could solve the labour shortage problem. For example, the service industry is struggling to find workers – many found other areas to work in during the pandemic when all businesses were closed and now are not interested in returning (Tuul, 2021). The replacement of those workers with robots seems like an excellent idea, however this in turn will cause issues for many sectors like service, manufacturing, transportation with people losing their jobs.

Economists agree that robotisation will in turn increase income inequality, which is already causing many issues in society. According to Guardian (2021) there would be winners and losers with this trend. Jobs with certain trade skills, complex human interactions and intellectual work would probably be safe. Finding a way that everyone can thrive in the society with many service, manufacturing and routine jobs disappearing is going to be huge challenge in the upcoming decades (Ford, 2021).

## 11 FDI strategy

Estonia's FDI strategy is mainly focused on incorporating value added activities. 2020 goals for attracting foreign direct investment were – creating a more attractive investment environment, attracting more investment, improving and expanding on already existing investors and companies and to reap even more benefits from re-investments. The focus fields were research and development, automatization and digitalisation. The recent near-shoring trend has been utilised as well as Enterprise Estonia is focusing more on regional companies (EAS, 2021).

### 11.1 Incentives

There are varied incentives offered to companies that want to invest in Estonia. Financial incentives are offered to companies planning to open a shared services or research centre, to large investors, the industrial sector to gain new jobs in Ida-Virumaa region and product development centres (EAS, 2021). Tax incentives are also used to attract investors – 20% tax rate and no taxes on reinvested and retained profits.

### 11.2 E-residency

Estonia offers the option of e-residency, to attract more foreigners to register their business in Estonia as well as gaining access to the EU business environment and e-services – business account and banking, declaring taxes, managing a company is all available online. The interest has been large from countries like Russia, Ukraine and Turkey as well as the UK after the Brexit vote (Dettoni, 2018). There are over 80 000 e-residents from 174 countries which has brought Estonia 16 500 businesses, 1700 jobs and 54 million EUR net income. E-residency brings in benefits like economic growth and promoting Estonia abroad (Republic of Estonia, 2021).

## 12 Analysis and conclusions

Estonia has greatly benefitted from FDI flows and it could be argued that the small country needs the capital flows for continued growth. The country has many strengths like the open business environment, favourable tax system, innovation and high level of digitalisation. However, the poor demographic outlook and external shocks can affect the economy negatively in the future.

Since the restoration of independence, the FDI flows surged due to privatisations and large M&A types of investments in the telecommunications, banking and real estate sectors. Nowadays Estonia is actively seeking value added greenfield investments and has done well in attracting many projects which will in turn cause positive spill overs.

The most common reasons why companies choose Estonia as a FDI destination were the stability of economy, skilled labour, tax system, digitalisation, presence of technologies as well as location. In the past cheap labour and electricity prices were considered more important, but it is prevalent now that the situation has changed in the past decade and is more geared towards high value-added activities, rather than saving costs on labour. These reasons are highly dependent on the home country situation as well. For example, some companies expressed that Estonia has a lot of complex bureaucracy in terms of applying for financial grants while firms from Germany stated that compared to their own country, bureaucracy was very easy to deal with.

The nearshoring trend has really benefitted Estonia as it is between East and West and close to other Baltic countries as well as Nordic countries. Setting up a business is easier and less expensive than in, for example, Scandinavian countries which makes Estonia a good destination for value added FDI.

Estonia's reputation for being technologically advanced has also brought in a lot of investments – developments in IT, robotics, digitalisation, automation were reasons stated by most of the recent investors. Many investors were seeking

out the university students as well as investing into the Estonian education system, which will gain them valued workers in the future.

As Dunning and Lundan (2008) explained that companies can be either market, efficiency, strategic asset or natural resource seekers. From analysis we can identify which investors would fall into which category. From the table we can see that most of the recent investments are market or efficiency seeking, which is in line with findings from Varblane et al (2020).

Table 1. Dividing investors to different categories.

<b>Market</b>	<b>Efficiency</b>	<b>Strategic asset</b>
Swappie	HANZA	Swedbank acquiring Hansapank in 1999
MCF	Birkle It	Telia acquiring Elion/Eesti Telefon 2014
	Stora Enso	
	Volkswagen	

In the second table investment decision is analysed through the OLI advantages – ownership, location and internalization advantages through the MNE perspective.

Table 2. OLI advantages

<b>Company</b>	<b>Ownership</b>	<b>Location</b>	<b>Internalization</b>
MCF	First and biggest data centre in region	Favourable tax system	Closeness of Eastern European markets
Stora Enso	Leading global renewable material solutions	Skilled workers and technological advancement,	Growth potential and local

	company strong innovation and supply chain	automation, robots and digitalisation	business environment
HANZA	Sustainable manufacturing, growth of 300% during pandemic, clients like ABB, Siemens and Saab	More efficient and quicker business operations as well as using local labour force	Nearshoring and ease of logistics
Birkle IT	Fast growing IT consultancy company, front runner in modern IT solutions	IT expertise and digitalisation present	Less “red tape” and bureaucracy compared to Germany, cost optimization
Arvato	Established global financial company, over 7000 employees in 20 countries, provides secure payment flows, Europe’s 3 <sup>rd</sup> largest financial service provider	IT expertise, working with students from TalTech and Tartu universities, cultural fit	Further intensify expertise and expand in the IT environment
Volkswagen	Huge global company, massive investment power – billions to be invested to digitalisation of vehicles – 60% growth expected by 2025	Presence of AI, digitalisation of vehicles, presence of self-driving start-ups	Ensuring competitiveness in global markets with self-driving technology

## 13 Recommendations

### 13.1 Long term dynamic plan for attracting foreign direct investment

The current Enterprise Estonia strategy is to attract value added and capital-intensive investment especially in the research and development, digitalisation and automation fields. Improving the position of already existing foreign companies is important and should be focused on. However, the question remains if these types of goals are sustainable.

#### 13.1.1 Improving the labour situation

As outlined beforehand, there is not enough highly skilled labour to support technology and science intensive industries. Even though this is being developed, the changes will not occur quickly and will take years or even decades.

- Estonia should invest in education – re-learning of adults should be promoted more as well as cooperation between companies and universities should be increased to ensure real skills are obtained that are actually beneficial in work place.
- Such a small population would benefit from using foreign workforce, but in order to attract foreign workers, Estonia needs to be an open and welcoming society.
- The idea of automation in the manufacturing sector is great way to reduce the amount of low skilled labour required.

#### 13.1.2 Wider approach to FDI

Estonia should have a wider approach to FDI, the heavy focus on specific fields can cause imbalances in the society and labour market.

- The huge focus on AI and automation is further going to reduce low skilled jobs and will require more high skilled workers.
- On the other hand, focusing on being successful in high skilled sectors will cause issues in society, as it is not reasonable to assume that a big part of the population will be able to learn new skills and engage in lifelong learning. Especially if Estonia is not very strong in the area in supporting adults learning. This will further already rising income inequality and societal issues.

### 13.1.3 Infrastructure

In order to become more attractive, a country needs to have a well-developed infrastructure. Improvements to Estonia's infrastructure are needed.

- Rail Baltic is planned to start construction in 2023 and discussions about the Tallinn-Helsinki tunnel are still ongoing. The railway would stretch from Poland to Finland. However, both projects have been stalling for years. Additionally, the linkages between cities can be improved as well as improving air traffic to other European countries

### 13.1.4 EAS specific suggestions

- According to Varblane et al (2021) many investors did not use Enterprise Estonia services due to the complexity and bureaucracy. EAS should have a wider approach to investors.

### 13.1.5 Focusing on environmentally friendly sustainable solutions

Estonia is very reliant on its oil shale, which is not sustainable in the long run. The transition could be especially difficult as 70% of the country's energy comes from oil shale as well as many jobs in Ida-Virumaa region are reliant on mining and energy creation.

### 13.1.6 Pursuing alternative avenues to FDI

It's been long argued that FDI can have a negative impact on domestic firms and domestic investment. Jude (2019) looked at 10 Central and Eastern-European countries between 1995-2015 (including Estonia) and found that the effects depend on the type of FDI as well as differ in short and long term. M&A's tended to not have an effect on domestic investment or to change the competition in the market while greenfield FDI created "creative destruction" meaning domestic competition was crowded out. However, in long-term domestic investment is stimulated when trade linkages are established creating additional demand. Crowding out in financial markets could restrict access for domestic firms and decrease overall national wealth. Even though the long-term effects on overall national wealth were positive following problems could arise – unemployment and denationalization of certain industries, which could be seen as a threat to national security.

Relying on FDI as a major source of capital for a country might not be sustainable in the long run, with the recent downturn in flows, the competition between countries is intensifying. The global "bidding war" is making governments offer fiscal (taxes, re-investment) and financial incentives (grants, loan guarantees) which can cause market distortions and lowering of global standards on protecting worker's rights and the environment. On country level discrimination can occur towards local firms and sectors. This is somewhat prevalent in Estonia as well, Enterprise Estonia clearly prefers certain types of investments over others. It has been argued that the money spent trying to attract FDI could actually be invested domestically, for example, into education or infrastructure which would benefit the country in the long run (Oman, 2000).

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