FOREIGN DIRECT INVESTMENT AND ENTERPRISE PERFORMANCE IN TRANSITION COUNTRIES: EVIDENCE FROM RUSSIA AND UKRAINE

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Abstract

This study compares the performance of foreign firms with domestic ones in Russia and Ukraine, using recent survey data of 450 enterprises. We find that foreign owned firms are less prone to inter-enterprise arrears and wage arrears, have a better export performance, and use more sophisticated competition strategies. Foreign investment appears to enhance entrepreneurial know-how. In case of de novo firms foreign investment often led to a 'jump start' of the enterprise, rather than a gradual adjustment over time. Foreign firms have a positive spill-over effect. They introduce healthy financial management methods, and proliferate badly needed market oriented entrepreneurial know-how through the managerial market.

Keywords: foreign direct investment, transition economies, entrepreneurship, growth.

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FOREIGN DIRECT INVESTMENT AND ENTERPRISE PERFORMANCE IN TRANSITION COUNTRIES: EVIDENCE FROM RUSSIA AND UKRAINE.

1. Introduction

The aim of this article is to investigate the effect of foreign direct investment on the performance of firms in transition countries. Especially we look at the aspects of finance and entrepreneurship. Other areas of firm management that are influenced by the foreign capital input are investigated as well. The methodology is empirical. On the base of firm level survey data the performance of firms that have received foreign direct investment is compared with the performance of firms that did not receive foreign funds. The data come from an enterprise survey that was carried out in the second half of 1997 covering 450 firms in St. Petersburg, Russia, and Kiev and the eastern regions of Ukraine. The sample was stratified. Half of the enterprises are de novo firms and the other half are state owned and privatised enterprises. The goal of the survey was to investigate the effects of entrepreneurship on firm performance. Consequently no specific sample stratification with respect to foreign ownership was adopted. Given the stratification with respect to firm type the selection of the number of firms with foreign direct investment can be considered random. The sub-sample of firms with foreign direct investment (FDI) comprises 34 firms.

Quite a few studies emphasise the positive effects of foreign direct investment on the performance of the firm. FDI fulfils the need for long-term investment capital (see for example Sudol, 1993; Carlin et al, 1994). Capital markets in the CIS countries are in their infancy. Long-term loans are virtually non-existent, and stock market flotation is not a feasible option for all firms (EBRD, 1998). In this environment receiving FDI might make the difference between survival and exit. FDI might be an important means to bridge the financial constraints faced by the entrepreneur. Evidence from central

European firms showed that FDI was usually accompanied by substantial investment and updating of the production process (Carlin et al, 1994; Dabrowski, 1995).

FDI was also found to be an important vehicle for the transfer of technology (see for example Borensztein et al, 1995). Introducing new technology often requires substantial sums of money as well as access to sources of know-how. Given the immature state of the capital market in transition countries and the different technological development path compared to the West it is a major challenge to obtain both technological know-how and the financing of the investment, in which it is embodied, in the local market (Bilsen and Lagae, 1997). It was also found that firms receiving FDI had a better export performance and especially an easier access to established market economies (EBRD, 1998).

One expects that a better access to investment funds and technology will be reflected in a higher productivity outcome. Recently, Aitkin and Harrison (1999) found that in the case of Venezuela FDI is positively related to productivity in small enterprises but that the effect was not significant for large firms. Djankov and Hoekman (1998) investigated the effect of FDI on productivity for medium sized and large firms in the Czech Republic. They concluded that FDI did not have a significant positive impact and that firms without FDI were apparently able to catch up with the latest technology through other channels, in particular trade.

Drawing lessons from these studies it is argued that FDI provides long-term investment capital, stimulates the transfer of technology, increases productivity and promotes export to established market economies. The evidence also suggests that the productivity effects of FDI are particularly important for small firms.

Other studies suggest an indirect route through which FDI influences firm performance, namely spill-over effects. Looking at evidence

from new industrialised countries, Markusen and Venables (1997) found that FDI leads to increased competition for the local firms on the output and factor markets, resulting in a reduction of profits. Yet supply linkages for complementary industries may lead to the establishment of local industrial sectors. Gow and Swinnen (1998) found empirical evidence that FDI spurred the restructuring of agricultural output markets in transition countries leading to strong output, yield and investment responses within sectors and across adjacent sectors. Aitkin and Harrison (1999) found for Venezuelan manufacturing firms that FDI negatively influences the productivity of the indigenous firms. Contrary to that, Blomström and Sjöholm (1999) concluded for Indonesian enterprises that foreign firms had a positive spill-over effect on the labour productivity of domestic firms.

Almost all the empirical evidence cited above is based on evidence from established (Western) market economies and Central European transition countries. There is still a considerable gap to be filled in knowledge of the effects of foreign direct investment on firm performance in the CIS countries. On the one hand one might argue that what works in the Central European transition countries works as well for the CIS countries. From this perspective the same results are expected as the ones cited above. On the other hand there are considerable differences between the Central European countries and the CIS countries. Not the least to mention is the different pace of transition towards a market economy (EBRD, 1998).

Another important difference is the history of these countries and its impact on the entrepreneurial spirit. The CIS countries were more than seventy years under rigid communist planning, coming from a mainly agrarian economy with little experience in market type firm management and entrepreneurship. It is questionable whether a Euro invested in this type of environment generates the same type of entrepreneurial spin-offs as in the Central European transition countries. Even under communist planning there were more opportunities for small-scale entrepreneurship in, for example,

Poland, Hungary and Yugoslavia than in the countries of the Soviet Union. Furthermore, parents or grandparents could witness from a starting industrial market economy before the Second World War.

An aspect in which we are particular interested in and which received little attention in the debate is the relation ship between entrepreneurship and management. Borensztein et al. (1995) argue that a condition for an FDI related technology transfer to result in higher productivity is that the host country has a minimum threshold stock of human capital. This suggests that entrepreneurial know-how is an important factor in the explanation of the results of FDI on company performance. Case study evidence suggests that FDI was often accompanied by a transfer in managerial know-how (Bilsen and Lagae, 1997). However more systematic evidence for transition countries is lacking to our current knowledge.

The methodology to uncover the effect of foreign investment on the growth and performance of enterprises in the CIS countries is basically empirical. In the sample of 450 firms from St. Petersburg, Kiev and the east Ukrainian region that were surveyed, we found 34 firms that received FDI. Since there was no specific stratification of the firms with respect to foreign ownership, the selection of firms with FDI can be considered as random within the strata of pre-transition firms and de novo firms. They come from the same population of firms. The performance of the group of firms with FDI was compared with the performance of the firms without FDI, which acted as the control group. For obvious reasons there is no foreign investment in state owned enterprises, leaving two remaining firm types, privatised and de novo firms.

The main findings are that firms that received FDI were less prone to inter-enterprise arrears and wage arrears. Foreign firms were found to have a better export performance, and to use more sophisticated competition strategies and better management practices. In case of de novo firms foreign investment often led to a ‘jump start’ of the

enterprise, rather than a gradual adjustment over time. This suggests that FDI does indeed transfer managerial and technological know-how to the former CIS countries. Human capital played an important role in the attraction of the foreign capital. A basic condition for obtaining FDI is in many cases a minimum entrepreneurial know-how necessary to make the venture work. Additionally FDI stimulates the entrepreneurs of the foreign owned firms to increase and update their entrepreneurial human capital through self-study and courses. Two positive spill-over effects of FDI were found. First, depending on the supply linkages with the domestic firms, foreign enterprises might help to reduce the inter-enterprise debt cycle. Second, our results suggest that an important part of the knowledge transfer to the domestic firms goes through the managerial labour market.

In the next section we briefly present the sample and its properties on which the analysis is based. Subsequently we take a close look at the firms that received foreign investment funds. In the following section the performance of the firms with FDI is compared with the firms that received no foreign funds. The last section draws the various findings together and concludes.

2. The Survey Data and Survey Environment

The data that we use come from a survey carried out as a part of the above mentioned TACIS-ACE funded research network. The goal of that survey was to investigate the determinants of firm growth and particularly the effect of entrepreneurship in de novo firms and in state owned and privatised enterprises. The survey was designed with this goal in mind. Within that framework aspects of FDI were investigated as well. In total 450 firms were surveyed equally distributed over three different regions: Kiev, East-Ukraine and St. Petersburg. Within each region the sample was stratified according to 50% de novo firms and 50% traditional firms, being state owned and privatised firms. The traditional firms were selected from the manufacturing sector only. De novo firms were selected from

manufacturing, trade and services. No other sample limitations were implied other than those referred to. The interviews for Ukraine were conducted in summer 1997 and those for Russia in winter 1997[1]. On average the interviews lasted for about one to two hours. Apart from basic aspects for the identification of the firm, the questionnaire covered entrepreneurship and finance as well as competition, employment issues and production. For a more detailed description of the questionnaire we refer to Bilsen and Mitina, (1998).

The regions from which we sampled can be labelled as core regions of Ukraine and Russia. St. Petersburg is one of the major economic centres of Russia. In 1997 it came second in attracting FDI after Moscow[2]. Together with Moscow it contains the highest educated population among all Russian regions (Brock, 1998). Kiev is the capital of Ukraine, hosting 5% of the Ukrainian population and accounting for 40% of all FDI up to January 1998 in Ukraine[3]. The East Ukrainian region comprises the cities of Dnepropetrovsk, Donetsk, Kharkiv, Lugansk, and Zaporizhzhya. It contains 33% of the Ukrainian population and attracted 19% of all FDI into Ukraine. The East Ukrainian region is known for its concentration of heavy industry and was during the pre-transition period part of the industrial heart of the Soviet Union. Table 1 gives an overview of the firms in the sample by region, firm type and size.

Table 1 shows clearly the sample set-up and stratification across de novo firms and the other enterprises. After having received more detailed information about the ownership structure and the history of the firm through the questionnaire a number of firms were reallocated to another firm type group, which explains the difference from the original stratification. The average size of de novo firms is substantially smaller than that for the other types of firms, a finding that is consistent with that of other studies (e.g. Bilsen and Konings, 1998). They are mostly small enterprises while the privatised and state owned firms are mostly medium sized and large enterprises. The sampled firms in Russia were on average larger than those in Ukraine.

The biggest de novo firm in the St. Petersburg sample was a subsidiary of a well-known Western company producing elevators, supplying mainly the CIS market. The largest enterprise in East Ukraine operates in the agricultural processing industry. The one in St. Petersburg produces tractors and steel products. The small enterprises in the group of state-owned firms are owned by municipalities, and were as such classified as state-owned. The small privatised enterprises resulted from split-ups of previously state-owned enterprises in the course of the privatisation process.

3. The Firms with Foreign Direct Investment: Description and Distribution

We inquired about the ownership structure of the company at the moment of the interview as well as the previous ownership composition. Respondents were asked to list the percentage of the total assets owned by particular types of owner of which one option stated "private investors outside the country". FDI-firms were defined as firms where the outside investors had a positive share in the ownership structure[4]. Table 2 gives an overview of the firms that received foreign capital investment by country.

Table 2 shows that a somewhat higher percentage of FDI-firms were sampled in Ukraine than in Russia, namely 9% versus 5% of the respective samples. This does not necessarily mean that Ukraine is more successful in attracting investment projects than Russia. Looking at the location of the firms in Ukraine we find that 17 of the 26 FDI-firms are located in Kiev. To the degree that FDI tends to be located in the capital areas, the figure for Russia might be underrepresented.

The average share of foreign investment is higher for the Russian sample than for the Ukrainian. This could mean that foreign investors are more reluctant to invest in Ukraine than in Russia. Yet other explanatory factors such as the legal background and the type of

foreign direct investment are equally valid candidates for explanation. For both countries the share of the foreign investor increased over time compared to the share in the start-up capital. This can be interpreted in two ways. The first interpretation is that the foreign investors try to gain control over the business. A second interpretation is that the foreign investor fulfils the need for capital that only can be obtained at costlier terms on the local market.

Another observation is that the average size of the FDI-firms in Russia is significantly bigger than in the Ukrainian sample. Part of the puzzle on the size differences can be solved by looking at the distribution of FDI-firms by firm type. Table 3 shows that in the Ukrainian sample far more de novo firms received foreign investment than privatised firms, while for the Russian sample the reverse holds. De novo firms have on average a significant smaller size than privatised firms, as noted above. Hence the lower is the average employment size. Note that the higher frequency of de novo FDI-firms in the Ukrainian sample also helps to explain why more Ukrainian FDI-firms in our sample concentrate on trade and services.

Why does the Russian sample show relatively more foreign capital investment through the privatised firms than the Ukrainian sample? Although one has to bear in mind that the sample is relatively small to reflect fully the underlying population distributions, the different privatisation progress in both countries might explain part of the picture. By 1997, the year of the interviews, Russia had showed more progress in privatising firms than Ukraine (EBRD, 1998, p26).

An interesting question is in which branches do the firms operate that receive foreign capital funds? It reveals part of the purpose of the investment and consequently sheds more light on potential effects within the enterprise. Table 4 shows the distribution of FDI-firms by sector and country. Almost half of the FDI-firms were sampled from the manufacturing sector. This is consistent with the sectoral distribution of the sample in which the FDI-firms were found[5].

Looking in more detail at what the FDI-firms produced we found a concentration of 8 firms in one particular manufacturing industry, namely food and beverages. The other manufacturing firms were operating in a broad range of markets, including furniture, cosmetics, gas analysers, TV programmes and telecommunications apparatus. Four firms were engaged in metal manufacturing. The two Ukrainian firms with another branch than the ones specified on the questionnaire operated in construction and research. Studies investigating the sectoral distribution of FDI in central European countries find as well a relative importance of FDI-firms in the food and beverages industry (Bilsen and Lagae, 1997; Meyer, 1995a,b). Often a major motivation for this industry to be present in the transition countries is the distribution of its products to the domestic markets.

To conclude this section we look at the distribution of FDI-firms over the type of foreign investment. Following the OECD (1994), five types of FDI are distinguished. Greenfield investments were defined as enterprises that were started up by foreign investors and where the start-up was completely financed by the foreign owner. The information came from two questions. One asked how the business was started. The other question inquired about the various sources for financing the start-up of the enterprise. Joint ventures were defined as firms that were started up by the foreign investor and/or the domestic partner and with a foreign ownership share in the start-up capital of less than 100%. The information was derived from the same questions as for the greenfield investments. Acquisitions were defined as firms wholly or partly in the hands of foreign investors at the moment of the interview, but with no participation in the start-up of the enterprise. Within the group of joint ventures a distinction was made between the joint ventures involving the creation of a new firm and joint ventures with existing enterprises, which can be either private or privatised. The group of acquisitions was divided between majority and minority acquisitions. Table 5 exhibits the types with the respective number of firms and the average foreign participation within the group.

Almost one third of all the foreign investments in our sample is in the form of joint ventures for which a new firm was created. This is in marked contrast to the number of joint ventures with existing firms. This might point to substantial benefits from creating a new firm rather than developing the venture within the framework of an existing firm. For instance in the case of the introduction of a new product or service that was not present before transition. This finding is in line with the previous findings of Genco et al (1993). They conclude that one of the major benefits for the foreign investor of starting new firms is avoiding the inheritance of "antiquated management and production structures".

Another striking feature of the sampled FDI-firms is the relatively low number of greenfield investments. In central European transition countries like Poland this is one of the most preferred forms of foreign investment (Bilsen and Lagae, 1997). An obvious reason for choosing a greenfield investment over a joint venture is the control of the firm. Yet a greenfield investment requires a certain market transparency in the sense that a foreign owner has to be able to make his investment pay-off in that new location. When there is a high degree of locality specific knowledge and/or tacit knowledge, a joint venture might be a better form of investment. The relatively large share of joint ventures together with the relatively low number of greenfield investments points to gains connected with the nature of the local transition market.

A last remarkable characteristic of the FDI distribution by form is the relatively large share of minority acquisitions. We could not find a clear indication for the reason, other than the traditional motives for FDI. Eight out of the ten minority acquisitions are acquisitions of privatised firms. In two of these firms the foreign investor participated in the privatisation process, of which one was through voucher privatisation. The remaining six privatised firms received foreign investment after the privatisation was done. Two minority acquisitions were acquisitions of de novo firms.

4. Performance Differences between FDI-firms and Non-FDI Firms

In the following section, we try to find evidence whether or not firms with FDI perform differently from firms without FDI and if so, why? For a set of performance indicators and characteristics we conduct a traditional t-test. The H_0 hypothesis is that the average for the FDI-firms is the same as that for the non FDI-firms. Though we have to be careful not to draw hasty conclusions, these tests can be very useful in discerning the channels through which FDI affects firm performance.

4.1. Financial performance

A first obvious success indicator to look at is financial performance. In our survey financial performance was measured by five questions, which each highlight another aspect of the financial situation of an enterprise. We inquired whether the firm experienced financial difficulties and we asked the respondent to tick the year in which it happened, starting from 1989 until 1997. The proportion of firms that reported financial difficulties in each of the groups was not significantly different. Yet in the later years a significantly lower proportion of FDI-firms reported financial difficulties (see table 6).

Another indication of financial performance was captured by the question on the liability structure of the firm. We asked respondents to provide the percentage of all liabilities that were regular and overdue according to the type of creditor. The overdue liabilities were further divided according to length. Table 7 shows that FDI firms have on average a significantly higher share of regular liabilities to firms and employees. In their payment relations with the banks and the budget we did not find a significant difference with the behaviour of the control group, although the average share of regular liabilities was slightly higher for FDI-firms.

The question arises then why do foreign enterprises have more regular payments to the firms and employees than indigenous firms? We inquired about the structure of the receivables in the same format as for the liabilities. Table 8 shows that enterprises that receive FDI have a significant higher share of regular receivables from firms. Together with the evidence on liabilities this suggests that in their inter-firm payment relations FDI-firms rely less on inter-enterprise credits and they are able to obtain from their customers more regular payments. Although not statistically significant, the average share of regular receivables from households and banks is markedly higher for the FDI-group compared to the non-FDI firms, which supports the argument[6].

Looking at the income side of the firm's finance, we also investigated the average number of days that the payments were delayed. Here as well statistically significant differences between firms with and without FDI can be found as showed in table 9. Firms that receive FDI have on average less than half of the delay in payments period compared with firms that do not receive FDI.

The last aspect of financial performance that we investigated was the profitability of the firm. We asked " Did the profitability of your company since last year: 1. Go down, 2. Remain the same, 3. Go up?" We did not find statistically significant differences in the evolution of profitability since the year before the interviews. 41% of the firms with FDI reported a deterioration of their profits in 1997 compared to 1996 against 51% of the firms in the control group. Yet the averages are not different at a statistically significant level.

To conclude on the financial performance we found that the firms that received FDI have on average a better liability structure than enterprises without FDI. Especially in the field of inter-enterprise arrears and wage arrears they score significantly better. On the one hand one might perceive this as an obvious result of the foreign capital injection. The foreign investor provides the necessary finance

for a smooth start and operation in the first years of operation. Yet on the other hand other aspects seem to drive this result as well. FDI-firms perform better on the side of receivables. Especially for receivables coming from firms the performance of FDI-firms is markedly better. Furthermore the average delay in payments in terms of days for the FDI-firms is more than half that for the non-FDI firms.

4.2. Financial management views

The subsequent question that arises is then: why is financial performance better for FDI-firms than for non-FDI firms? We gave the opportunity to the respondents to answer this question. We asked them to rank the most important reasons for the accumulation of the overdue liabilities and to give a single rank. The list of options included overdue receivables, expensive bank credit, it is a normal practice, wages come first, serving bank credit comes first, taxes come first, absences of resources on the current account, sales are too low, no overdue payments and others. Looking at the average values of the rankings, non-FDI firms listed overdue receivables as the most important reason, followed by taxes and subsequently wages[7]. FDI-firms listed "taxes come first" as the most important reason, and subsequently overdue receivables and wages (see table 10).

Note that 52% of the FDI-firms pointed to overdue receivables as the most important reason, compared to 57% for the control group. Furthermore, a higher proportion of FDI-firms gave low rankings in the range from 3 to 9. There was less variance in the non-FDI group about overdue receivables being a major cause for overdue liabilities than in the FDI-group.

This result is consistent with the previous result that FDI-firms have a higher share of regular receivables than non-FDI firms, which in turn leads to less overdue liabilities. The finding that taxes are a more important reason than overdue receivables and wages for the FDI firms to explain their overdue liabilities might indicate that these firms

find it difficult to predict or incorporate the impact of the tax legislation on the financial situation.

Another difference is that although wages are in both groups the third most important reason for overdue liabilities, FDI-firms give a significant lower value for it than the control group. FDI-firms perceive to a lesser degree that the wage bill is an important reason for overdue liabilities.

This evidence points to another question, what are the payment priorities of the firm? We inquired about the liabilities of the firm according to its priority. Four options were listed ranging from 1, most urgent payment to 4, least urgent payment. Table 11 gives an overview of the results.

FDI-firms do not differ in their payment priorities compared to the non-FDI firms. Both give highest priority to paying taxes, followed by payments to firms, wages and the lowest priority the banks. However the average priority for the liabilities to the employees differ significantly between both groups, with FDI-firms giving a lower average priority than the control group, which is consistent with both the results on the reasons and the actual pattern of liabilities.

We also asked how do you keep your overdue receivables under control? The answers on this question did not give any decisive difference between FDI and non-FDI firms. Neither did the question on filing for insolvency of the client. This suggests that the better financial position on the receivables side is not so much driven by different financial management strategies, as least insofar the potential differences could be captured by the questionnaire. In the next sections we investigate the sales and market, production and technology, and entrepreneurial characteristics.

4.3. Sales and export performance

We compared the export performance of the FDI-firms with that of the control group in terms of the share of total sales on the foreign market for three years, 1990, 1994 and 1996. The results are presented in table 12.

Table 12 clearly shows that FDI-firms have a significantly higher share of their total sales coming from foreign markets than firms in the control group. This aligns with the evidence found in the central European transition countries (EBRD, 1998). The question arises why do they export more? Note that this question is related to the motivation of FDI. Is it cheap factors of production that make multinational firms invest in these countries in order to be ahead of competition on the global market? Or is it the size of the Ukrainian and Russian market that attracts foreign investment? In the first case one should indeed expect a high export share. In the second case, sales in the home country would be more important.

We investigated the market orientation of the firms by asking in which market the majority of the products and services were sold and gave the following options: 1. Local, 2. Regional in the meaning of oblast, 3. National, 4. The CIS market and 5. International. The results are shown in table 13. It is clear that FDI-firms are oriented to international markets while firms in the control group sell more in the local market. Interestingly though, FDI-firms operate equally strongly on the national and CIS' markets, contrary to the non-FDI firms. It is worthwhile noting that although the export share in FDI-firms is significantly larger than for non-FDI firms, still around 80% of the output is sold on the domestic market, which is in line with the evidence on the market orientation.

4.4. Technology, investment and productivity

We asked, “did the company make an investment in new production equipment and machines since 1989 or start-up?” The question also inquired about the year in which the investment was made. Contrary to the conclusions of other studies on the effects of FDI in central European countries, we did not find a significant difference in investment performance between FDI and non-FDI firms. We deepened the analysis and investigated the investment performance for de novo and privatised firms separately. The same result appeared for privatised firms. However de novo FDI-firms invested significantly less than non-FDI de novo firms, as shown in table 14. This counter intuitive result might indicate that for de novo FDI-firms the investment in equipment and machines is made at the start of the enterprise, as a sunk cost, providing enough capacity for the first years of operation. This would imply that there is no need for new investments in the early years of operation for these firms. Since the question inquired about investments since start-up, the investments at or before the start of the enterprise are not captured by this question.

The results on the privatised firms are consonant with the findings of the literature. The proportion of privatised firms that made investments during the course of the transition period was higher for those that received FDI than for those that did not.

We also investigated the age composition of equipment and machines. FDI firms had on average a higher share of equipment aged 2 to 8 years compared to non-FDI firms: respectively 58% and 49%. On average 21% of FDI-firms’ equipment had an age between 9 and 25 years old compared to 30% of the non-FDI firms. Although the proportions are not statistically significantly different at the 5% level, they suggest that FDI-firms tend to operate with more recent technology than non-FDI firms. This supports the hypothesis of Borensztein et al. (1995) that FDI is a vehicle for technology transfer, and extends this result to the CIS countries.

We inquired about the change of productivity in the last two years before the interview. The respondents were asked to indicate whether productivity had declined, remained constant or increased since 1995. We did not find any statistically significant difference in the evolution of productivity between the foreign and indigenous firms. This suggests that whether one experienced an increase, status quo or decline in productivity did not systematically depend on receiving foreign capital or not. The result was robust controlling for firm type. Since de novo firms are mostly small or micro firms and privatised firms medium sized or big (see table 1), this result indicates that there is no difference according to size class.

The respondents were also asked to indicate whether their firm's productivity was higher, the same, or lower than the average productivity of the other firms in their sector. Within the group of de novo firms 39% of the foreign firms indicated that they did better than average, compared to 32% of the indigenous firms. Within the group of privatised enterprises 36% answered that they had a higher than average productivity compared to 26% of the indigenous firms. However these differences are not statistically significant at the 5% rejection level rendering these results only weak evidence in favour of FDI.

4.5. New products and R&D

Given the evidence on technology and investment, the question arises whether the technology transfer propels into an innovating strategy or not. We asked "how many people are involved with research and product innovation?" Excluding the state firms from our control group, we found that both foreign de novo firms and privatised firms have on average a higher number of people who are involved with R&D.

We did not find significant differences between FDI and non-FDI firms on the introduction (or sale) of new products and services during the early transition period. An equal share of 56% for both the FDI and non-FDI groups introduced new products and services in the period 1990-1993. However for later years of the transition, a slightly lower percentage of the FDI firms introduced new products, 61% for FDI firms compared to 74% for non-FDI firms. Controlling for firm types, the results are clearer. Table 16 shows that within the group of privatised firms the introduction of new products and services does not differ so much between the two groups of firms. Contrary to what one might expect, a lower proportion of the de novo FDI firms introduced new products and services in the period 1994-1997. Again, one could argue that they started with the right set of products and services from the beginning and consequently the need to introduce new ones would be less.

4.6. Entrepreneurial strategies and background

We inquired about the sales strategy of the firm. Respondents were asked to give a ranking of a set of given aspects according to the importance for the firm. The items listed were: low price, high product quality, fast delivery, providing seller's credit, sales location, reputation, after sales support and "other". The most significant differences were for after sales support and low price (see table 17). On average non-FDI firms gave a higher priority to low price than FDI-firms. FDI-firms in contrast gave on average a higher ranking to after sales support. Note that both types of firms gave the highest ranking to high product quality.

The evidence on the marketing mix suggests that FDI and non-FDI firms compete in a different way. While non-FDI firms tend to compete with the 'classical' instruments of price and quality, FDI-firms extend their competition instruments to after sales support. Thereby they sell more than the product alone, adding the use, repair and follow-up as well. Basically they offer in that way a different

product from their competitors and at the same time stay in close contact with the market's wants.

Why do the FDI-firms tend to have a more sophisticated marketing strategy than non-FDI firms? Factors that might explain the result are experience and background as well as learning from the foreign firm. On average the entrepreneurs in FDI-firms have less private management experience, as shown in table 18. At the same time they tend to be younger than their colleagues in the control group.

This suggests that experience as such is not the decisive key factor that makes FDI-firm management different from non-FDI firm management. We deepened the analysis further and investigated the management background of the entrepreneurs and especially whether they had any experience from working in a foreign firm. We asked, "what was the management background of you and your colleagues in the key management team?" One option listed "worked in a foreign company". Table 19 shows the results for the respondents and for their colleagues of the management team. There were 4 FDI-firms where the respondent worked in a foreign firm and 5 enterprises where the other members of the management team had foreign firm experience. There was one firm where both the respondent and his colleagues worked in a foreign firm before, making the total of FDI-firms where the management had foreign company experience equal to 8 out of 34 cases or 24% of the FDI sub-sample.

Table 19 clearly shows that the proportion of firms with management experience in a foreign company is lower for the group of non-FDI firms than for the FDI-firms. Relating this piece of evidence to the more elaborate competition strategy of the FDI-firms suggests that the experience of working in a foreign company is an important factor in explaining the relative successes of FDI-firms.

We also explicitly inquired about the sources of entrepreneurial learning by asking from what source the respondent learned most for

operating his business. The average values for each type of learning source are presented in table 20. Self-study from books and courses receives the highest rank for both FDI and non-FDI firms. However, FDI-firms give it on average a higher ranking than non-FDI firms. The opposite is true for the experience from the previous job. Although both types of firms rank it as the second most important, non-FDI firms gave a significantly higher ranking than FDI-firms. For other sources of learning no systematic difference was found.

4.7. Entrepreneurial goals and problems

The last important part of the empirical investigation looks at the goals that the entrepreneur wants to achieve with respect to his firm. We inquired about the management objectives that were considered as most important for the firm. Table 21 shows the proportion of firms within each sub-sample that marked a particular objective as most important.

It is clear from table 21 that a lower proportion of FDI-firms are focussed on increasing profits, finding extra investment capital and introducing new technology. To conclude that these aspects are not an issue for FDI-firms might be a bit too hasty. It might be that these areas of firm management are fulfilled in a large part of the FDI-firms and consequently might not be an important management objective. Note that a slightly higher percentage of the FDI-firms have the objective of finding well trained managers, yet this percentage is not significantly different from that of the control group.

What are the most important problem areas in realising one's business plan? What prevents the above mentioned goals from being realised? We asked about the most difficult aspects in realising one's entrepreneurial ideas. It is striking, yet not surprising, that FDI-firms have significantly less difficulties in finding capital. This is consonant with previous evidence on financial performance. Almost half of the FDI-firms cite the contact with the authorities as difficult compared to

only one third of the control group. Similar evidence was found from surveys in central European countries (OECD, 1994).

A lower proportion of FDI-firms tended to have difficulties in finding an appropriate place, building or land, in developing a good business plan and in pursuing other people about the profitability of their ideas. More FDI-firms reported having difficulties with finding qualified and skilled personnel than non-FDI firms. However these aspects are not statistically conclusive.

5. Putting the Pieces Together

The goal of this article was to investigate the effect of FDI on enterprise performance in the CIS countries. We used new empirical evidence coming from a survey of 450 firms in East-Ukraine, Kiev and St. Petersburg, carried out in 1997. Within that sample 34 firms were identified that received FDI. Their identification can be considered as random within the sample stratification of the mother sample. We sampled firms in manufacturing, trade and services. The sampling approach also implied that in contrast with most FDI studies on central and east European countries that look usually to the major foreign investments beyond a certain size cut-off level, we selected from the fast growing small sized new private firms as well. More than half of the foreign firms were located in Kiev. The Ukrainian sample differed from the Russian in the sense that for Ukraine almost two thirds of the FDI-firms were de novo firms while for Russia the opposite was the case. Russian FDI was mostly located in large privatised firms.

Contrary to evidence for central European countries we found only a small number of greenfield investments in the region. One third of the FDI-firms were in the form of joint ventures whereby a new firm was created. This is consistent with the finding from studies on central European countries that one of the major benefits of starting a new firm is to avoid the inheritance of old unsuited management and

production structures. The only difference in our sample compared to studies from the central European countries is that the form of setting up of new enterprises differs. In central European countries foreign investors tend to set up new firms more through greenfield investments, while in our sample it happened more through joint ventures. Two explanations for this phenomenon can be found. First the Land Code in Ukraine did not allow foreigners to own land, not even for legitimate business purposes (OECD, 1997). This creates a considerable problem in setting up greenfield investments, which by definition are fully foreign owned. Second, given the Land Code, foreign investors might nevertheless prefer a joint venture with a local participant because of his tacit knowledge about the local entrepreneurial culture and the local market conditions.

The latter explanation also sheds light on another interesting finding. Almost one third of the foreign investments took the form of a minority acquisition. From the point of view of control, one would expect a majority ownership. It provides a better control on the allocation of the profit and on the firm management and its performance. Trust in the local management team combined with their necessary know-how about the local market conditions and business culture seems to us important to explain this finding.

Several performance indicators were investigated such as financial performance, export performance, technology and innovation. We found strong evidence that FDI-firms have on average a better term structure of their liabilities compared to non-FDI firms, especially for liabilities to firms and wage arrears. Note that by paying wages more regularly, foreign owned firms implicitly provide higher expected wages than indigenous firms. We also perceived that FDI-firms perform significantly better on receiving regular payments, especially from firms. This suggests that FDI-firms are more able to stay out of the circle of inter-enterprise arrears and that their financial situation is healthier than that of the domestic firms. This was also confirmed by the differences in management objectives. The need for finding

investment capital and for improving profits was significantly lower ranked in foreign firms than in domestic ones.

Ickes and Gaddy (1998), investigating restructuring in Russian enterprises, recently argued that the large amount of inter-enterprise arrears and overdue wage payments was part of a deliberate management strategy to demonetise the operation of the firm in order to avoid excessive taxation and rent seeking from organised crime. In their view the lack of employment reduction was 'financed' by wage arrears. Our findings add to this discussion that FDI-firms are evidently less prone to this type of management behaviour and consequently introduce healthy management practices in their respective industries. To the degree that the foreign firm uses domestic resources and intermediate supplies they help to reduce the spread of inter-enterprise debt.

FDI-firms tend also to sell a markedly larger part of their production on the export market than non-FDI firms do. Yet they are also more oriented towards the host country or oblast, contrary to the non-FDI firms, which are mostly focussed on local markets. Contrary to what other studies on central European transition countries concluded, we did not find that FDI makes a difference in investment behaviour for privatised companies. Furthermore it was even perceived that in comparison to the control group, a lower proportion of de novo firms that received FDI made investment during their course of operation.

Similar evidence was found for the introduction of new products and services in the second half of the transition period. In comparison to the de novo firms in the control group a lower proportion of de novo FDI-firms introduced new products and services. These elements suggest that FDI resulting in the start-up of a new firm gets the company in shape right from the beginning rather than going through subsequent adjustments and adaptation.

On average foreign firms worked with more recent equipment and machines than domestic firms, indicating that FDI does indeed update the production technology as suggested by Borensztein et al (1995). However the differences were not statistically significant, preventing us from putting too much emphasis on this result.

We did not find any statistically significant differences in the evolution of productivity between foreign and domestic firms, even after controlling for firm type. Whether an increase, status quo or decrease of productivity was reported did not depend on having received foreign investment or not. Note that we inquired about the evolution of the productivity. It might well be that the differences occur especially in the levels with foreign firms having a higher productivity than domestic firms. We found weak evidence that foreign firms have indeed higher productivity levels, especially amoung the privatised enterprises.

Investigating entrepreneurial characteristics we found that almost one third of the FDI-firm's entrepreneurs had previously worked in a foreign company. They also attached a high ranking to self-study as a source of learning for the operation of their enterprise. FDI-firms tended to have a more sophisticated competition strategy on the output market as well. This sheds new microeconomic evidence on the relation between human (entrepreneurial) capital and FDI. While it is often argued that FDI brings additional know-how into the domestic company, these results suggest that there has to be a minimum entrepreneurial know-how already in place in order to attract FDI as argued before by Borensztein et al (1995). The entrepreneur has to be acquainted with the foreign (Western) enterprise culture and ways of operation. This suggests that part of the perceived better entrepreneurial know-how and management ideas in foreign owned firms were already present before any foreign investment was received. However it seems to be equally important once the foreign investment is made that the domestic entrepreneur who is in charge of

the venture keeps up to date and increases his entrepreneurial human capital.

The above mentioned findings indicate an important positive spill-over benefit of foreign investment operating through the managerial labour market. If being exposed to the enterprise culture and practices of a foreign firm improves the probability of obtaining FDI when one starts his/her own firm, FDI might proliferate the attraction of further FDI and consequently disperse greatly needed management practices in the sector or even in the country.

Quite in contrast to the perceived positive effects of FDI both on the firm itself and through the spill-overs, a number of striking difficulties still remain in the operational (macro) environment. Half of the foreign firms indicated that their contacts with the authorities were the most problematic area of entrepreneurship. This is consistent with evidence from other studies that highlight the frequent changes in the legislation and the unclear formulation of the relevant laws (see for example OECD, 1997). Another problem field is the immaturity of the capital markets. Although FDI meets the need for long term investment capital, still 40 % of the foreign firms cited finding capital as the most difficult part of entrepreneurial endeavour. In order not to lose the perceived benefits of foreign investment both countries should take care of the quality of the relevant laws and regulations, both in terms of formulation and stability over time. Continued efforts to develop the capital market is another, yet long-term, goal to be aimed at.

Notes

1. Which means before the outbreak of the Russian debt crisis. Anecdotal evidence suggest that the Russian crisis flawed the interest of potential foreign investor seriously, yet that the ones who were present continued to operate as planned.

2. For an overview of FDI in the former Soviet Union and the Russian regions see Brock (1998) and Meyer and Pind (1998).

3. Source: Ministry of Statistics, Ukraine. The data for Kiev comprise FDI for Kiev city plus FDI for the remainder of Kiev Oblast.

4. We are aware that this definition is different from the definition used by the United Nations and the IMF who introduce a minimum threshold of 10% (see e.g. Sheehy, 1992, p.2). We did not introduce a minimum value because we wanted to investigate all potential effects of foreign investment and not only the aspect of firm control. However, there were only two firms where the foreign investor owned less than 10% of the assets.

5. It has to be noted that no firms operating in the primary sector were surveyed. This explains the difference with findings from other studies that FDI in Russia is strongly linked with the energy sectors; see for example EBRD (1998) and Meyer and Pind (1999).

6. Note that the average share of regular receivables from the state offices is for both types of firms markedly lower than for other categories of debtors. This classifies the state as a dubious client.

7. Answers with the value 0 for “not applicable” were excluded because this would bias the results.

Table 1: The distribution of firms by type and region, and the corresponding average size

Region / *Firm type*	**East Ukraine**	**Kiev**	**St. Petersburg**	**Total**
State Owned				
No. of firms (sample share)	12 (8%)	17 (11%)	15 (10%)	44 (10%)
Employment Average (min; max)	195 (16; 787)	826 (25; 3834)	1004 (3; 3199)	713 (3; 3834)
Privatised				
No. of firms (sample share)	68 (45%)	59 (39%)	56 (37%)	183 (41%)
Employment Average (min; max)	458 (6; 12000)	510 (32; 4035)	1189 (6; 12446)	695 (6; 12446)
De Novo				
No. of firms (sample share)	70 (47%)	74 (49%)	79 (53%)	223 (49%)
Employment Average (min; max)	24 (0; 170)	34 (2; 300)	40 (0; 1200)	33 (0; 1200)
Total				
No. of firms (sample share)	150 (100%)	150 (100%)	150 (100%)	450 (100%)
Employment Average (min; max)	242 (0; 12000)	313 (2; 4035)	581 (0; 12446)	376 (0; 12446)

Note: The data on employment are those for the year 1996. Source: own calculations.

Table 2: Characteristics of the sampled firms with FDI

	Ukraine	**Russia**	**Total**
Number of FDI-firms	26	8	34
Average employment in 1996	187	731	306
Average share of FDI	41%	63%	47%
Average share of foreign investor	39%	46%	41%

in the start-up capital			

Table 3: Firms with foreign investment according to firm type (% distribution)

Type	**Ukraine**	**Russia**	**Total**
- De novo	62%	29%	55%
- Privatised	38%	71%	45%

Table 4: FDI-firms by sector and country

Branch	**Ukraine**	**Russia**	**Total**
- manufacturing	10	6	47%
- trade	6	0	17%
- services	2	1	9%
- trade + services	2	1	9%
- other	2	0	6%
- manufacturing + trade	1	0	3%
- manufacturing + services	1	0	3%
- manufacturing + trade + services	1	1	6%

Table 5: FDI-firms according to type of foreign investment

FDI type	Number of FDI-firms(1)	Average ownership share (%)
Greenfield	4	67
Joint venture, creating a new firm	12	45
Joint venture with existing firms	3	41
Acquisition, majority stake	4	82
Acquisition, minority stake	10	25

(1) For one firm the type of FDI could not be determined.

Note that for all greenfield investments the foreign investor provided 100% of the start-up capital. Yet in two cases the share of the foreign owner at the moment of the interview was substantially less, but still a majority share.

Table 6: The proportion of firms that experienced financial difficulties in 1996 and 1997

	Non FDI-firms	FDI-firms	p-value
Financial difficulties 1996	0.76 (0.02)	0.54 (0.09)	0.01**
Financial difficulties 1997	0.71 (0.02)	0.54 (0.09)	0.05**

Note: P-values lower or equal than 0.05 are marked with ** meaning that FDI-firms are significantly different from non FDI-firms at the 5% level. P-values between 0.10 and 0.05 are marked with *. Standard errors are between brackets.

Table 7: The average share of regular liabilities by type of creditor

	Non FDI-firms	FDI-firms	p-value
% of regular liabilities paid to firms	52.18 (2.84)	68.9 (8.45)	0.077 *
% of regular liabilities paid to banks	71.35 (5.71)	88.33 (8.3)	0.31
% of regular liabilities paid to wages	47.43 (5.05)	86 (14.0)	0.048**
% of regular liabilities paid to budget	60.62 (3.86)	71 (10.85)	0.39

Table 8: The average share of regular receivables by type of debtor

	Non FDI-firms	FDI-firms	p-value
% regular receivables from firms	41.72 (2.45)	63 (7.66)	0.007**
% regular receivables from households	61 (6.19)	76.67 (12)	0.49
% regular receivables from banks	54.29 (19.38)	96 (4)	0.31
% regular receivables from state	28.38 (4.73)	27.5 (12.64)	0.95

Table 9: The average period in number of days of delayed payments

	Non FDI-firms	FDI-firms	p-value
Average delay in payments from customers in number of days	47.87 (4.74)	17.97 (3.82)	0.08*

Table 10: Reasons for the accumulation of overdue liabilities (1=most important/9=least important)

	Non FDI-firms	FDI-firms	p-value
Overdue receivables	2.42 (0.13)	2.65 (0.48)	0.62
Wages come first	3.66 (0.10)	4.35 (0.36)	0.06*
Taxes come first	2.82 (0.1)	2.38 (0.25)	0.19

Table 11: Ranking of the liabilities according to payment priority (1=most urgent payment, 4=least urgent payment)

Creditor	Non FDI-firms	FDI-firms	p-value
State budget	1.73 (0.06)	1.83 (0.19)	0.61
Banks	3.10 (0.07)	3.08 (0.17)	0.89
Wages	2.38 (0.05)	2.80 (0.15)	0.01**
Firms	2.31 (0.06)	2.10 (0.22)	0.28

Table 12: The average share of total sales on the foreign market for FDI and non-FDI firms

	Non FDI-firms	FDI-firms	p-value
Share in 1990	2.69 (0.79)	17.0 (8.04)	0.0001**
Share in 1994	4.21 (0.78)	18.46 (6.39)	0.0000**
Share in 1996	5.52 (0.78)	15.22 (5.33)	0.002**

Table 13: Geographical sales orientation of FDI and non-FDI firms (Percentage of firms within each group that sells the majority of its product and services on a certain market.)

Market type	Non FDI-firms	FDI-firms	p-value
Local	0.70 (0.02)	0.47 (0.09)	0.005**
Regional (oblast)	0.47 (0.02)	0.50 (0.09)	0.72
National (country)	0.31 (0.02)	0.47 (0.09)	0.05**
CIS market	0.08 (0.01)	0.21 (0.07)	0.02**
International (other than CIS market)	0.07 (0.01)	0.15 (0.06)	0.10*

Table 14: Investment activity in FDI and non-FDI firms by firm type

	Non FDI-firms	FDI-firms	p-value
Investment of de novo Firms	0.88 (0.03)	0.67 (0.14)	0.04**
Investment of privatised firms	0.71 (0.05)	0.82 (0.12)	0.47

Table 15: The average number of people involved with R&D in FDI and non-FDI firms by firm type

	Non FDI-firms	FDI-firms	p-value
De novo Firms	4.14 (0.49)	23.5 (19.7)	0.0004**
Privatised firms	9.42 (3.34)	28.18 (8.70)	0.10*

Table 16: The proportion of firms that introduced new products or services in the period 1994-1997 for FDI and non-FDI firms by firm type

	Non FDI-firms	FDI-firms	p-value
De novo Firms	0.78 (0.03)	0.53 (0.12)	0.02**
Privatised firms	0.70 (0.04)	0.71 (0.13)	0.94

Table 17: Importance of marketing mix (1=most important/ 9=least important)

	Non FDI-firms	FDI-firms	p-value
After sales support	5.05 (0.13)	4.07 (0.42)	0.04*
Low price	2.33 (0.09)	3.06 (0.37)	0.03*
High product quality	2 (0.07)	2.26 (0.32)	0.28

Table 18: Average years of private management experience and age of the entrepreneurs in FDI and non-FDI firms

	Non FDI-firms	FDI-firms	p-value
Average age of the entrepreneur	42.5 (0.51)	37.3 (1.79)	0.004**
Average years of private management experience	7.9 (0.39)	5.2 (0.84)	0.04**

Table 19: Proportion of firms where the management had experience in a foreign firm

	Non FDI-firms	FDI-firms	p-value
Respondent worked in a foreign company before.	0.03 (0.01)	0.12 (0.06)	0.006**
Other members of the management team worked in a foreign company before.	0.03 (0.01)	0.15 (0.06)	0.0004**

Table 20: Sources of entrepreneurial learning in FDI and non-FDI firms. Average rank by source (1=most important / 8=least important).

	Non FDI-firms	FDI-firms	p-value
University/technical education	3.45 (0.11)	3.42 (0.22)	0.93
Previous job	2.68 (0.10)	3.32 (0.38)	0.07*
Suppliers	5.12 (0.12)	5.33 (0.57)	0.67
Clients	5.05 (0.11)	5.19 (0.48)	0.75
Programs outside the traditional education system	4.86 (0,14)	4.77 (0.60)	0.85
Your family	5.81 (0.18)	5.75 (0.58)	0.93
Self study from books, courses	2.25 (0.08)	1.85 (0.23)	0.16
Learning by doing	3.36 (0.09)	3.53 (0.27)	0.59

Note: answers with value 0 for “not applicable” were excluded.

Table 21: Proportion of firms that consider a particular management objective as most important in FDI and non-FDI firms

	Non FDI-firms	FDI-firms	p-value
Lower cost production	0.43 (0.02)	0.44 (0.09)	0.88
Increase market share	0.55 (0.02)	0.50 (0.09)	0.57
Produce new products	0.28 (0.02)	0.24 (0.07)	0.59
Introduce new technology	0.23 (0.03)	0.12 (0.06)	0.17
Finding well-trained workers	0.13 (0.02)	0.06 (0.04)	0.25
Finding well-trained managers	0.10 (0.01)	0.15 (0.06)	0.35
Finding extra investment capital	0.26 (0.02)	0.12 (0.06)	0.06*
Increase profits	0.48 (0.02)	0.29 (0.08)	0.04**

Table 22: Proportion of FDI and non-FDI firms that consider a particular area of entrepreneurship as most difficult

	Non FDI-firms	FDI-firms	p-value
Pursue other people of the profitability of your idea	0.18 (0.02)	0.09 (0.05)	0.18
Finding capital	0.59 (0.02)	0.42 (0.09)	0.06*
Contact with the authorities	0.33 (0.02)	0.48 (0.09)	0.07*
Finding a place, building or land	0.09 (0.01)	0.03 (0.03)	0.23
Developing a good business plan	0.12 (0.02)	0.09 (0.05)	0.60
Avoiding excessive taxation of profits	0.42 (0.02)	0.34 (0.09)	0.43
Finding qualified and skilled personnel	0.18 (0.02)	0.25 (0.08)	0.36

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