WHO IS AFFECTING ESTONIA'S BUSINESS CLIMATE?

Piret Anton

This article aims to introduce a new field in statistics related to direct investment, which has gained more and more popularity in the world in recent years. In order to understand the scope of globalisation and the impact of one economy on another and to support foreign trade relations, economists have started to pay more attention to the economic activities of foreign-owned companies.

International groups play an important role in economic globalisation. To understand the scope of globalisation, it is necessary to analyse direct investment statistics as well as the impact of foreign groups on single countries. The latter depends on the activities of international groups in a particular country that affect the turnover, the number of the employed and labour costs. It also influences the value added, which may (but need not) be financed by direct investors, the value of the output, expenditure on innovations etc.

The impact of a particular country can be measured by placing all the above indicators under the residency of the so-called controlling entity; that is the country holding the ultimate control over the group in question. The type of statistics that measures the impact of international groups on a single country is called **Foreign AffiliaTes Statistics** (FATS). FATS is divided into two groups. The first is inward FATS, comprising companies registered in Estonia but controlled from abroad. The second is outward FATS, consisting of foreign subsidiaries controlled from Estonia. Inward FATS has been compiled in Estonia since 2003 within the framework of a project coordinated by the European Commission (Eurostat) and Statistics Estonia. Information about outward FATS is not gathered yet.

On June 20, 2007, the European Parliament and Council Regulation (EC) No 716/2007 entered into force. According to this Regulation, Estonia is obliged to submit outward FATS to Eurostat as of 2009, indicating the data of 2007. The compulsory indicators to be submitted include the turnover of companies controlled from Estonia, the number of the employed and the number of entities controlled. According to agreement, data is collected also about non-EU companies. Information about companies registered in the European Union is drawn from the "mirror image" of the inward FATS submitted by EU Member States and summed up by Eurostat. This image enables to distinguish the aggregate indicators of the companies controlled from Estonia. The integral picture is obtained by summing the two different sources.

Foreign direct investment reflects cash flows and their balance between companies belonging to one group and located in different countries. The origin of capital is defined by the direct investor or the foreign company belonging to the same group[1]. Foreign direct investment is characterised by 10–100 per cent direct or indirect holding in the equity capital. The

[1] Parent company together with its subsidiaries and associated companies.

direct investor need not have full control over the investment object – some other investors might have that control, even if the company in question is a subsidiary of a foreign enterprise. The geographical distribution of investment is determined by either the direct investor holding direct control or the creditor or debtor belonging to the same group. If there are no direct cash flows regarding the company holding full control, the impact of the respective country is not recorded in direct investment statistics. As foreign direct investment statistics reflect the movement of capital between the companies of a group and the related incomes, then co-financiers are reflected under other investment in the balance of payments statistics. Therefore, it is not possible to establish a direct connection to the creation of value added solely through the analysis of direct investment.

The status of a company having full control over the investment object is determined either by its holding in equity capital (50% or more of the voting shares or equity) or other influence on the company's financial and business operations. Control means, above all, dominant influence on a company's activities, whereas no other institution exercises dominant influence over the financial and business operations of the controlling entity. It is not easy to determine the controlling entity, as there are different kinds of dominant influence, such as indirect control[2], multiple minority ownership[3] and joint ventures with two foreign owners[4]. There is no geographical distribution in the case of the latter form; such companies are recorded in a separate category. Regarding multiple minority stake, the indicators are shown for the investor with the largest holding.

The present article analyses the activities of companies registered in Estonia and having at least 20 employees, as these companies are the largest also in terms of turnover. Based on the 2003 data of a survey conducted by Statistics Estonia,[5] these companies contribute 72% to the total value added. The survey did not include companies engaged in agriculture, forestry, fishing and financial intermediation.

At the end of 2004, there were 3,537 companies with at least 20 employees registered in Estonia and primarily owned by domestic entities (81%). Five per cent of the owners had included also foreign investors, without losing their power of decision. 19% of the companies were foreign-owned and 26% of them were exercising indirect control (see Table 1).

---

[2] Indirect control – the parent company has no direct holding. It exercises dominant influence, for instance, through a subsidiary with a more than 50% holding in the equity capital of the investment object.

[3] Multiple minority ownership – a company has, for instance, three investors from different countries, whereas none of them has a larger holding than 50%. In that case, the country of the controlling entity is determined by the largest holding.

[4] Joint ventures with two foreign owners – a company has two investors with equal holdings. The indicators of such companies are recorded separately under the code of an agreed country.

[5] Source: *Financial Statistics of Enterprises 2004*, Statistics Estonia.

Table 1. Number of enterprises (20 or more employees) registered in Estonia by the country of origin of the controlling entity (as at 31/12/2004)

	All companies*	Companies with foreign ownership	
Country		Number	Share (%)
Finland	220	171	6.2
Sweden	124	93	3.5
United States	48	30	1.4
Germany	45	42	1.3
United Kingdom	34	23	1.0
Netherlands	31	26	0.9
Denmark	29	27	0.8
Norway	27	12	0.8
British Virgin Islands	14	7	0.4
Austria	12	6	0.3
France	12	11	0.3
Switzerland	10	8	0.3
Rest of the world	78	49	2.2
Controlled by non-residents (total)	684	505	19.3
incl. EU (except Estonia)	547	421	15.5
incl. euro area	331	265	9.4
Controlled by residents (total)	2,853	140	80.7
Total	**3,537**	**645**	**100**

* Excluding agricultural, hunting, forestry and fishing companies and financial intermediaries.
Sources: Statistics Estonia and Eesti Pank

By fields of activity, residents' control is most dominant in the construction sector (95%) and the least present in the industrial sector (75%). EU Member States are controlling an average of 16% of the enterprises. Finland and Sweden prevail in terms of countries: they control half of the foreign-owned companies. The control of foreign countries is the largest in the industrial and trade sector and the smallest in the sectors of health care, education and other community, social and personal services (see Figure 1).

The analysis points directly to the higher efficiency of Estonian companies under foreign ownership (19%). These companies create 40% of the value added, which in 2004 totalled as much as 285,000 kroons per employee. The respective figure for domestically owned companies is 100,000 kroons less, that is 185,000 kroons. Foreign-owned companies also accounted for 40% of the net sales. Investment in fixed assets enables to expand business operations, enhance efficiency and increase turnover. Compared to domestically owned companies, the fixed investment of foreign-owned companies is considerably higher. All in all, this enables to reduce the number of employees needed in the production process and pay nearly 25% higher wages. In 2004, the average labour cost per employee was 112,000 kroons in Estonian capital based companies and 139,000 kroons in enterprises based on foreign capital (see Figure 2).

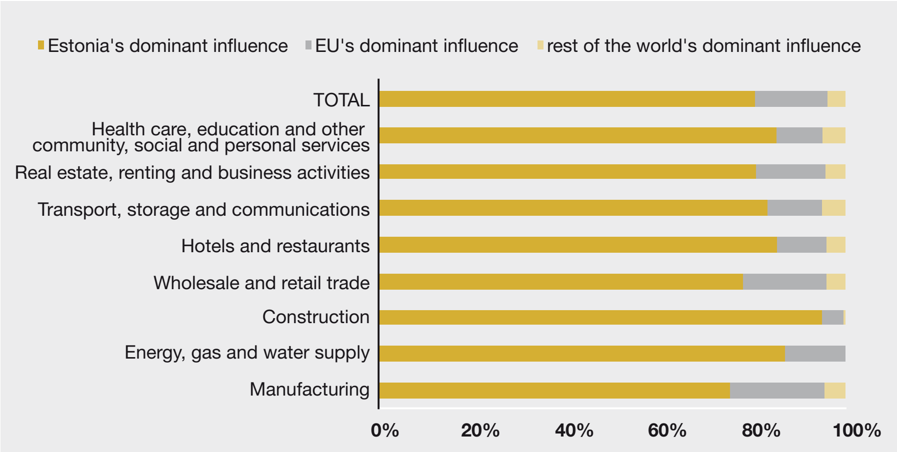

Figure 1. Dominant influence in companies registered in Estonia (20 and more employees) by residence and fields of activity (as at 31/12/2004)

The analysis of foreign capital[6] shows that companies controlled by the rest of the world include much more foreign capital compared to companies owned by Estonian residents. Two thirds of foreign external funds and foreign equity capital obtained by the companies ana-

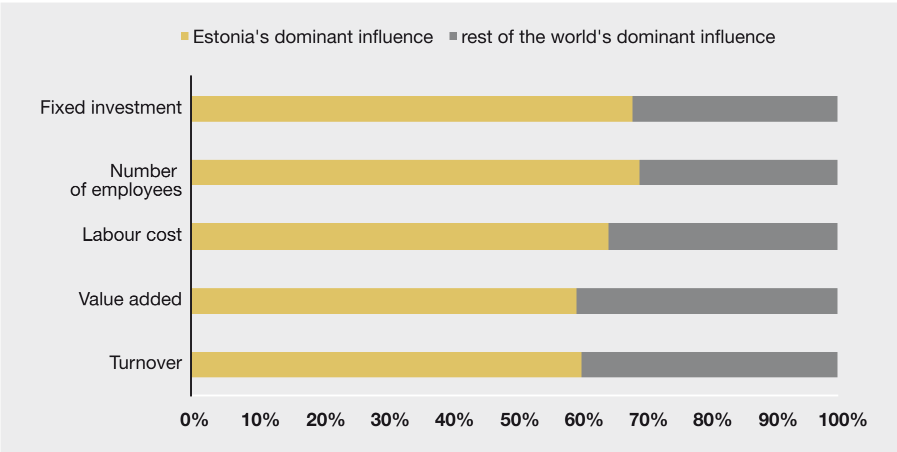

Figure 2. Distribution of key economic indicators for 2004 by dominant influence in companies

[6] Foreign capital analysis involves contractual obligations, such as short- and long-term loans, capital lease and debt securities, and equity capital. The analysis does not include trade credit, other liabilities or financial derivatives.

lysed are recorded in their balance sheets; the rest is considered liabilities to be repaid by companies controlled from Estonia. The analysis of direct investment data comprises only intra-group external liabilities and assets, excluding other credit sources, whereas the analysis of the total external funds shows that 29% of obtained loan instruments and equity capital investment have been invested by foreign banks or other creditors not related to the group in question (see Figure 3). The percentage of equity security investment is relatively high (37%). The companies controlled by domestic investors have been divided into two: companies with either direct or indirect foreign shareholding and companies that are hundred per cent based on domestic capital. Compared to the former, the latter also accounts for a higher share in the balance of external funds, with debt securities comprising 43% of them. The volume of external liabilities of domestically and foreign-owned companies is rather small. Over half (54%) of the external funds raised have been invested in equity capital.

Figure 3. Types of foreign capital included by companies registered in Estonia (20 and more employees) by dominant influence (as at 31/12/2004)

To conclude, it can be said that based on available data, the Estonian economy is still largely domestically owned. However, foreign-owned companies appear to be more effective. They invest more in innovation and have easier access to foreign capital. 60% of the fully foreign-owned companies are under the dominant influence of Finland, Sweden, Denmark, Norway and Iceland. As the Estonian financial sector is also predominantly controlled by the Swedish and Finnish banking sectors, we can conclude that the Nordic business culture and economic developments affect Estonia's economy a whole lot more than implied by the limited database used for the present analysis.