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# **FOREIGN DIRECT INVESTMENT IN SLOVENIA**

## **Attracting FDI and Optimizing the Effects**

by

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## **Abstract**

Foreign direct investment (FDI) is widely considered to be one of the main generators of so called spillover effects, where not only direct employment is a positive outcome but the whole economy can benefit in various ways. The recognition of spillovers has resulted in a more active role of host country governments to attract FDI. This thesis analyzes the FDI inflows in Slovenia and the role of public policies to enhance the positive spillover effects, in order to determine how the presence of FDI has affected the local economy. The increased openness towards foreign investors and the policies used to promote FDI are depicted. It is a qualitative case study, illustrating how the presence of the French automaker Renault in Slovenia and the government's involvement in the recent production expansion has affected the local economy. The results show evidence of positive spillover effects through backward linkages to suppliers, training of workers, and creation of indirect jobs.

**Keywords:** Slovenia, Foreign Direct Investment, Spillover effects, Public policy, Automotive industry, Renault

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## List of abbreviations

ACS	Automotive Cluster of Slovenia
CEE	Central and East European States
D.D.	Delniska družba, <i>Joint Stock Company</i>
D.O.O.	Družba z omejeno odgovornostjo, <i>Limited Liability Company</i>
EBRD	European Bank for Reconstruction and Development
EMU	Economic and Monetary Union
EPZ	Export Processing Zone
EU	European Union
FDI	Foreign Direct Investment
FYR	Former Yugoslav Republics
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
IMAD	Institute of Macroeconomic Analysis and Development
IMV	Industrija motornih vozil, <i>Slovene Industry of motor vehicles</i>
IPA	Investment Promotion Agency
JAPTI	Javna agencija Republike Slovenije za podjetništvo in tuje investicije <i>Public Agency of the Republic of Slovenia for Entrepreneurship and Foreign Investments</i>
M&A	Merger and Acquisition
MNC	Multinational Corporation
NACE	Statistical Classification of Economic Activities in the European Community
NLB	Nova Ljubljanska Banka
OECD	Organization for Economic Co-operation and Development
R&D	Research and Development
SEZ	Special Economic Zone
SFRY	Socialist Federal Republic of Yugoslavia
SORS	Statistical Office of the Republic of Slovenia
TRIM	Trade Related Investment Measure
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

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# **1. Introduction**

The Republic of Slovenia became an independent state in 1991 after the disintegration of former Yugoslavia. The country has made a transition from a socialist federal republic to a free market economy in a very short period and in the smoothest way possible. Slovenia has taken such important measures in its transition as joining the WTO, NATO, the European Union, and the European Monetary Union. At the end of 2006 the economy's GDP real growth rate was 5.2 percent while GDP per capita was 14 700 EUR, making Slovenia one of the most prosperous economies among the new EU member states and at the same level as Greece and Portugal. Integration and extensive trade with the European Union were strong contributors to the healthy economic development. On the other hand, a significantly smaller share of GDP growth can be accounted to foreign direct investment (FDI) in Slovenia, much as a result of the privatization methods chosen by the Slovenian government. However, other factors have also attributed to this outcome.

This is a study on FDI and the positive way in which the foreign firm might affect the host country. The rising flows of FDI in the world are evidence of the increasing importance of this subject in contributing to individual countries' economic growth. To what extent the host economy actually benefits will to a great part depend on the attitude that the State has towards multinational companies entering the local market. Trade barriers, competition, tax levels, and legislation regarding business activities are all factors which the local government can affect in order to facilitate FDI inflows and maximize the positive outcome.

## **1.1 Statement of purpose**

The objective of this thesis is on the one hand to explore the impacts that FDI has on the hosting economy and on the other hand to investigate how the local economy – more specifically the local government – can maximize the positive effects which arise from FDI. The paper deals with the specific case of Slovenia's inward FDI, with illustration of the automotive sector. The recent introduction of a new car model in Renault's manufacturing plant in Slovenia and the direct involvement by the Slovenian government to encourage this expansion, helps answer the questions how FDI can be promoted and the spillovers optimized.



## **1.2 Methodology and material**

This paper is a qualitative study focusing on earlier theoretical research on determinants of FDI, spillover effects, and public policy to attract investment. By investigating an occurrence where the government has been involved in increasing FDI, it is possible to show that the economy as a whole in reality has much to gain from a more active public policy towards inward FDI.

The primary empirical research on FDI in Slovenia is collected from the Central Bank of the Republic of Slovenia, with the EU statistical database, Eurostat and the Public Agency of the Republic of Slovenia for Entrepreneurship and Foreign Investments, JAPTI as secondary sources of data. As regards to the case study of Renault in Slovenia, the analysis is based on information from the web sites of Renault and its subsidiary Revoz, as well as an interview with the communications department of Revoz. Valuable financial data has also been acquired through JAPTI.<sup>1</sup> The theoretical framework on FDI, spillovers, and public policy is based on numerous earlier published studies.

## **1.3 Definitions and limitations**

As we are looking at an increasingly globalized world, where firms are allowed to move across borders more freely, it is interesting to see which impacts these increasing levels of mobility might bring. Therefore, the focus lies on foreign direct investment. Slovenia's political and economic history will only shortly be scrutinized. A more detailed presentation on the subject, along with analysis of Slovenia's trade patterns has been done in the author's bachelor's thesis, *Slovenia and the EU – A Study on Integration, Trade, and Specialization*.

In the instances where the European Union members are analyzed, the integrated area is considered as either EU15 or EU25,<sup>2</sup> that is to say Romania and Bulgaria are not included in the analysis, as they joined the EU in January, 2007. In the cases where only the EU is mentioned, this is in reference to EU25.

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<sup>1</sup> The sources of JAPTI and the communications department of Revoz are engaged in promotion of FDI in Slovenia and the activities of Revoz respectively. Therefore, the plausible presence of bias in the sources should be taken into consideration.

<sup>2</sup> EU15 consists of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom. EU25 additionally includes the Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia.

## **1.4 Disposition**

The first part of this thesis is a theoretical chapter on FDI, the motives of multinational firms to invest abroad, and the various spillover effects that direct investment might have on the hosting economy. Chapter three is dedicated to the theory of public policy measures which the host economy can undertake in order to absorb the positive effects of FDI and minimize the possibly negative impacts. In the same chapter, an outline of the measures and incentives provided by the Slovenian government are given. Chapter four gives a statistical overview of the inward FDI in Slovenia. Stocks, inflows, and distribution of investments by countries and activities are presented. This data is analyzed and the chapter is completed with a depiction of the comparative advantages that Slovenia can offer to investors. The next chapter centers on the automotive industry, where first the trend of FDI in the Central and East European states is portrayed, followed by a presentation of the Slovenian automotive industry. The chapter continues with a detailed investigation of the car manufacturer Renault's production in Slovenia and its impact on the local economy. The last chapter summarizes, provides policy implications and suggestions on further research.

## 2. FDI – motive and impact

When an international investment project takes place in the form of FDI, there are always two actors being affected – the investor and the objective of the investment, i.e. the host country. This further opens for the prospect of mutual benefit. The theories on FDI and spillover effects are outlined in the following sub-chapter. First, the motives for the foreign firms to invest and to choose a specific country are considered, followed by the actual effect that the direct investment can have on the FDI-receiving economy.

### 2.1 Motives and determinants of FDI – The investor perspective

#### 2.1.1 Considering the advantages

When analyzing multinational corporations (MNCs) and FDI, it is essential to determine the factors affecting a firm's decision on why and where to make an investment. When facing such challenges in the host economy as new laws and regulations, cultural and language differences, as well as additional communication and transportation costs (Markusen, 1995, 395), the MNC needs to know that it can expect extensive advantages that can compensate the extra costs.

#### Box 2.1 Definition of FDI

- The internationally applied definition of FDI is presented by the Organization for Economic Co-operation and Development (OECD). It is stated that an investment counts as a FDI when the objective of a resident entity in one country is to engage in a long-term relationship in a firm located in a country other than that of the investing entity. Examples of such relationships can be *inter alia* parental/daughter enterprises or mergers and acquisitions (M&A).
- The recommendation made by the OECD is that a direct investment enterprise is defined as such when a single foreign investor owns a minimum of 10 percent of the affiliate's voting shares. One of the key features of a FDI is that the investor is able to influence the firm management.

Source: <http://www.unctad.org/Templates/Page.asp?intItemID=3146&lang=1> (09-05-2007) and OECD (1996)

An often applied model is the one constructed by Dunning (1993) (cited in, *inter alia* Markusen 1993 and UNCTAD 1998) where he presents three conditions for FDI to occur. Two of the conditions in the OLI-paradigm are firm-specific, i.e. *ownership* and *internalization advantages*, while the third one, *location advantages* is dependant on the specific conditions in the host country that can be of an advantage for the MNC.

*Ownership advantages* are any firm-specific advantages that can outweigh the inevitable costs of establishing business abroad. These advantages can be for instance technical knowledge,

advanced research and development (R&D), or management skill that can give the MNC extensive market power. Second, the MNC starts looking for *location advantages* in the foreign market in order to decide whether to invest abroad or not. The avoidance of such costs as transportation and tariffs as well as the access to cheaper factor prices and a larger market are some of the host-country determinants. These will be discussed in the next section. Lastly, a firm will make the decision of setting up production abroad if the product offered can be better utilized internally than if it for instance was licensed to a foreign firm. These are so called *internalization advantages*. One reason to transfer the firm product internally is the risk of knowledge assets “leaking out” when the MNC does not have direct control. Another can be the reputation of the product quality which can be under risk if the licensee starts prioritizing cost savings instead of production quality.

### **2.1.2 Host country determinants of FDI**

Even though the MNC also takes into consideration other location advantages except of the economic determinants, for instance policy framework for FDI and business facilitation (UNCTAD 1998, 91), mainly the economic specifics existing at entry in the host country will be examined in this section. The public policy measures are instead analyzed in the next chapter.

- For a foreign firm investing abroad, a crucial characteristic of the host economy is the *market size* (Janicki and Wunnava 2004, 507). Through the accommodation of a larger amount of firms, the larger market facilitates the creation of scale economies for the MNC. At the same time high *market growth* in the host country is an automatic magnet for both domestic as well as foreign investors (UNCTAD 1998, 107).
- For FDI focusing on production of labor-intensive end products, an important factor is the availability of *production factors* as well as the lower cost of these. Particularly for the MNCs who have certain production stages of the product that are more labor intensive is low-cost unskilled labor an essential criteria (UNCTAD 1998, 108). Bevan and Estrin (2004) confirm that one of the main factors influencing the MNC’s investment decision is the unit labor cost (p 783).
- Foreign investors seek to be close to other firms with similar production processes. This gives them the possibility to take part of R&D and face-to-face knowledge exchange in for instance science and technology parks. Thus, the presence of such *agglomeration economies* in the host country will attract further FDI (UNCTAD 1998, 113).

- A country's ability to affect the amount of inward FDI through the creation of an economically integrated area will depend on the integration form as well as the type of FDI that is coming into the country. MNCs that move a certain stage of their production processes abroad – so called vertical FDI (Shatz and Venables 2000, 8) – see lowered barriers to trade as a beneficial asset, enabling the firm to easily move across borders. On the other hand, horizontal FDI, where the main interest of the investor is to serve the local market can diminish as this can now be more easily done by exporting, once barriers to trade are lowered. Integration and trade agreements will be further discussed in the following chapter.

## **2.2 Spillover effects – The host economy perspective**

When examining the impacts, positive as well as negative, that the increase in FDI in fact represent, one should not only look at the MNCs motives and gains. Instead, by studying the literature on how the host country is affected by foreign investment, i.e. spillovers from FDI, it is possible to obtain even better knowledge of the mutual gain of FDI for the global economy. This sub-chapter begins with looking at the earlier theoretical work on spillovers as well as presenting the various types of this phenomenon. The positive and negative effects are also scrutinized.

### **2.2.1 The theory behind spillovers**

One generally applied definition of spillovers from FDI is that spillovers occur when the presence of a MNC results in an efficiency or productivity upsurge by the local firms in the host country, resulting after the MNC not being able to internalize these benefits in total.<sup>3</sup> The way that foreign firms differ from local ones is firstly through the internalization advantages mentioned earlier, which gives the MNC an opportunity to compete with the local firms, seeing as these firms already have other advantages, such as consumer preferences and expertise in the local market. Secondly, the mere presence of the foreign investor is bound to bring an imbalance for the local firms who are then required to alter their business approach in order to keep their market position. Both these factors are expected to produce some sort of spillover effect.

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<sup>3</sup> See for instance Görg and Greenaway (2004), Javorcik (2004), and Kokko (1992)

Earlier models and theories used for identifying spillovers can be summarized by a listing some main points. First, MNCs were expected to make a contribution to the local economy by training workers who would later apply their know-how if transferring to local firms. At the same time, the administrative and quality control techniques used by the MNCs would in turn increase the capacity of local suppliers and distributors. Moreover, the foreign investor could help or overturn local firms by either creating a more competitive market or increasing the monopolistic power in the industry, respectively (Kokko 1992, 30).

Another analysis was presented by Caves (1974) where the focus lies on three spillover effects. He begins with explaining how MNCs can reduce monopolistic power in the host country, creating “allocative efficiency.” Moreover, increased “technical efficiency” may occur if local firms feel pressured to become more competitive in the presence of MNCs. The last point that Caves mentions is an increase in “technology transfer” arising as a result of for instance recurring imitation of multinational firms’ technology and R&D products (p 176 ff).

For the remaining part of this chapter the focus will be on more recent studies on spillovers, where less attention is given to the question whether spillovers exist or not, but the focus instead lies on *how* these spillovers affect (in this case) the host economy (Kokko 1992, 31). Next, the spillovers will be divided into four groups along with a presentation of expected effects.

### **2.2.2 Types of spillovers**

A first type of spillover arises through *imitation* of the entering MNC, where local firms may adapt the investor’s knowledge of production processes and/or managerial skills (Görg and Greenaway 2004, 173). This can be a result of FDI more often ascribed to spillovers occurring in industrialized host countries, as these generally find it easier to imitate and absorb the advanced technologies presented by the MNC (Kokko 1992, 26). Moreover, the technology imports made by MNCs are often younger than those sold to outside firms through licensing, which effects firm efficiency more directly and encourages local firms to imitate (Damijan et al 2003, 4).

Another spillover channel can be found in the connection between the MNC affiliate and its suppliers and/or customers in the home country. The so called *backward linkages* occur *inter alia* through knowledge transfer from the foreign investor to the local supplier, higher product

quality requirements, as well as increased demand for intermediate products and thus larger economies of scale (Javorcik 2004, 607). Some of the positive effects would be that prospective suppliers could get assistance in setting up production, the MNCs could help in raising production and product quality of local suppliers, and they could train the suppliers in management and organization skills. *Forward linkages* and the positive effects of this spillover channel have not been as carefully studied. One connection between foreign investors and the local customers that has been made is the necessary contact in industrial application, where expertise from the manufacturer is required and the contact between the MNC and the customer is strengthened as a result (Kokko 1992, 47). Some empirical studies have shown that these downstream effects in fact exist and have a positive impact on the local economy (Zajc, 2006, 20 and Aitken and Harrison, 1991, cited in Kokko, 1992, 47). Linkages can also be defined as cooperation between the MNC and local universities, research and training centers or investment promotion agencies (UNCTAD 2001, 127). The overall effect and strength of backward as well as forward linkages would depend on such factors as level of local content in MNC production, the affiliate's market orientation (market-seeking vs. export oriented), technical capability of local firms to gain from the technology transfer, as well as which type of FDI is concerned, for instance a M&A or a greenfield project, i.e. investment in new production facilities (Zajc 2006, 20), seeing as local content in the foreign investment would increase the positive effect. Moreover, linkages seem to gain strength over time as local firms become more skilled and as local content in the MNC grows.

A third group of spillovers arises through increased *competition* in the host economy. As a MNC enters the market, the already existing domestic firms are faced with the presence of higher technology and are forced to improve their already existing production processes and thus yield productivity gains (Görg and Greenaway 2004, 174). The increasing number of firms in the market will therefore push towards enhanced competition in the local market. Moreover, Blalock and Gertler (2005) reason that competition effects can also work through backward linkages, where the MNC by transferring technology to more than one local supplier would provide the MNC with several sources of quality supply and at the same time encourage competition (p 81). However, Aitken and Harrison (1999) present empirical evidence of situations where foreign presence can reduce the productivity of local firms. This can happen under imperfect competition when MNCs locate in more productive sectors, increase production, and in that way draw demand from domestic firms who are forced to cut production. The negative outcomes will be further discussed in the next section.

Finally, spillovers can be found in the *training* and improvement of local human capital in the MNCs. Such training is a necessary part of the foreign firm's work in most industries, as most MNCs do not only require low-cost labor but also a certain level of skilled human capital (Görg and Greenaway 2004, 174). This type of skills acquisition either spills over through a direct channel where complementary workers gain new knowledge or through workers that move from the multinational firm to a local one and carry the knowledge with them. The training that the local workers gain varies from on-the-job training to overseas training in the parent company. In the end, it all depends on the required skills. In developing countries, this knowledge is considered to be of high importance and is also more documented, where the often lower levels of public education systems increase the importance of training spillovers (Kokko 1992, 48). In developed countries, the spillovers from skills acquisition can be mainly found in training of higher-skilled human capital and transfer of management skills.

### **2.2.3 Can spillovers cause harm and why?**

Although there are studies which have been carried out with the purpose of locating the effects of FDI on host economies indeed have presented positive outcomes, there is also evidence of negative or ambiguous effects.<sup>4</sup> Some of the most widely discussed negative impacts on the local firms in the host economy attributed to FDI are summed up as follows. First, the risk remains that firms already existing in the host economy can be forced out of business if their efficiency level is not high enough to meet the higher competitive standards required in the presence of foreign affiliates (Kokko 1992, 28). Therefore, if the response of the local firms is not strong enough, the result could be a more monopolistic industry. Moreover, competitive foreign firms could draw the demand away from the local firms and these would have to cope with increased costs of production and decreased productivity, as they would have to spread their fixed costs over smaller market shares (Aitken and Harrison 1999, 607). Another scenario is presented by Blalock and Gertler (2006) where multinational firms could "steal" talent from the local firms, creating a brain-drain effect. Furthermore, the research presents a situation where the presence of MNCs results in higher wages (for instance through pressure from the home country) but without the responding productivity increase, the overall effect would be negative (p 77).

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<sup>4</sup> Aitken and Harrison (1999), Djankov and Hoekman (1999), and Haddad and Harrison (1992)



To give reason for the mixed results that empirical analyses of FDI and spillovers have shown, several possible explanations could be applied. One reason could simply be that MNCs are skilled at internalizing all the productivity and R&D progress, thereby not making them available for the local companies. It could also be the other way around. Lipsey and Sjöholm (2005) argue that the domestic industry could be protected to the extent that not much space is left for local entrepreneurship. This would make the local firms less competitive as well as unable to absorb the positive spillovers. If the domestic sector is too small, the result could be that the firms could be crowded out by more efficient MNCs (p 40).

Javorcik (2004) portrays another situation where spillovers would not have a strong impact. She argues that partially domestic ownership of the FDI project rather than fully foreign-owned firms would create more spillovers as the first type would to a larger extent depend on imported inputs (p 609).

The absorption capacity or the lack thereof could be another explanation to the negative results. Görg and Greenaway (2004) state that advanced technologies and positive spillovers in general can be harder to absorb for the local firms. Therefore, a not too wide technology gap in combination with an absorptive capacity will improve the firms' chances to benefit from MNC presence (p 180 ff). This is a conclusion supported by Zajc (2006, 26). It is also assumed that geographical proximity and higher integration between local and investing firms is needed if the local companies are to absorb the spillover effects (Görg and Greenaway 2004, 181) and (UNCTAD 2001, 136).

A last point that needs to be taken into consideration is that the results of spillover effects of FDI could differ depending on data and time period used. As researchers have pointed out,<sup>5</sup> the panel data applied in the most recent tests can control for investor selection bias and thus give clearer results than with the earlier cross-sectional analysis. What is more, much of the data has looked at intra-industry spillovers, not taking into consideration the spillovers that could occur between sectors. Djankov and Hoekman (1999) also argue that developing and transition economies often need more time to adapt and learn of technology spillovers than is spanned in many empirical studies.

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<sup>5</sup> See for instance Kokko (1992), Blalock and Gertler (2006), and Görg and Greenaway (2004)

Conclusively, the theoretical work outlined in this chapter shows that despite the possibility of ambiguous effects from FDI on the host country, these impacts are very situation-specific. They are dependent on characteristics of the investing firm as well as the investment-receiving country. Moreover, the government in the hosting economy can influence many factors surrounding the FDI project in order to optimize the linkages. The policies to increase the positive spillover effects are presented next.

### **3. Public policy towards FDI**

Apart from recognizing the positive spillovers that can come from FDI, it is also crucial to understand in which way public policy can be used in order to optimize the effects. Chapter 3 gives an overview of the theory behind territorial competition as a way to attract FDI, as well as alternatives for the government to maximize the positive and minimize the negative effect of FDI. This is followed by a more detailed depiction of state measures used in Slovenia, the country of main interest to this qualitative study.

#### **3.1 Absorbing the positive effects of FDI**

As the number of MNCs in the world increases, the awareness of the positive impacts that these can have on the investment receiving economy has increased (UNCTAD 2006, 23). In comparison to portfolio investment and trade effects on the host industry, FDI is seen as a long-term undertaking by the investing firm. As earlier stated, the integration level and closeness to the foreign firm is a determinant for spillovers – horizontal as well as vertical – to take place. Depending on the investor's preferences, the MNC can take different measures to deepen linkages with local suppliers and customers. However, it is much up to the hosting government to create an environment where the MNCs can prosper and at the same time have positive influences on the local economy.

##### **3.1.1 Territorial competition**

One alternative for defining the actions taken by governments to attract and promote FDI is through territorial competition carried out between governments in the form of rules-based or incentives-based competition (Oman, 2000). *Rules-based competition* refers to changes in government action in order to make the market more attractive to foreign investors. For instance, by signing regional trade agreements with neighboring countries will create a larger potential market for the MNCs. Another rules-based action is the creation of so called export-processing zones (EPZs) (also called special economic zones, free ports, or science and technology parks) where the government implements more liberalized trade and investment regulations in a certain region, differing from the rest of the country. It is usually a way to attract export-oriented enterprises, as goods entering the EPZ can do this with limited or even free of duty requirements. Johansson (2002) summarizes the main objectives of EPZs as a way “to lure multinational enterprises into investing in the zones, and thereby promote non-

traditional manufacturing exports, reduce unemployment and disseminate foreign know-how and technology,” where linkages to the rest of the economy and associated spillovers would be created (p 388). Other aspects of rules-based competition are privatizations of state-owned firms as well as improved enforcement of intellectual property rights and the rule of law. *Incentives-based competition* on the other hand refers to fiscal and financial incentives implemented by economic jurisdictions in order to attract FDI. The most common forms of fiscal incentives are income tax rate reductions, tax holidays on sales, import duty exemptions, and investment and re-investment allowances. Financial incentives include grants from the government to the foreign investors, often specifically aimed towards for instance labor training, land donations, and loan guarantees for international lines of credit. The various types of territorial FDI competition, are playing an increasingly important role in the debate over motives for MNCs to choose certain investment locations over other, and are thus starting to compete with the traditional arguments for economic determinants presented in chapter 2. Countries and regions applying these various measures do this in differing combinations and to a varying extent.

### **3.1.2 Enhancing the impact of linkages**

It has already been suggested that much of the spillovers are created through contact and cooperation between the MNC and its suppliers, customers, as well as competing domestic firms, namely through linkages. They are associated among others with efficiency improvements through increased competition, enhanced access to local assets, and direct knowledge flows to the linked firms. Particularly the presence of backward linkages has been the focus of many recent case studies, where such research papers as Lin and Saggi (2005) and Javorcik (2004) emphasize the relatively larger impact that the MNC/supplier link might have on the local economy. An additional strength of backward linkages is that the costly efforts taken by the foreign affiliate make it harder for them to divest once strong linkages are created.

A significant part of the initiatives towards stronger linkages are taken by the foreign firms which have much to gain, as more suppliers that can meet cost and quality requirements implies higher efficiency and profits. Some options for the MNCs for attaining these linkages are through technology transfer, financial support, business information sharing, and/or providing training (UNCTAD 2001, 140 ff).

Nevertheless, it is above all the responsibility of the local government to create such a policy environment for the MNCs where they will feel encouraged to initiate and expand FDI and more importantly create linkages to the local firms. The various policy measures that the government can undertake to strengthen linkages will be presented, ranging from changes in tariff levels to linkage promotion programs. The public policy theory is mainly collected from UNCTAD's *World Investment Report, 2001*. In order to obtain the objective of increasing efficiency and technology diffusion in the local industry, the government needs to focus on policies that will lower the costs and raise the rewards of linkages (UNCTAD 2001, chapter V). The policies can be concentrated geographically, i.e. towards industry clusters, sector wise where industries are most active, and/or broader ranging with focus on skills creation and information exchange. Expressed more generally, the choice of linkage promoting measures should be adjusted to the specific economic environment prevailing in the country in question.

By setting higher tariff levels for imports of goods to the host economy or by having rules of origin in the presence of a preferential trade agreement, the local government can direct the FDI towards the local industry as this option will be relatively more cost efficient compared to trading with the region. However, such import substitution policies are disliked and deemed as too protectionist in international trade and investment agreements, at the same time as rules of origin do not necessarily guarantee that the multinational affiliates will choose local suppliers over internalized production or other foreign supplier firms established in the host country (UNCTAD 2001, 165). Thus, the positive linkage effect is not always guaranteed. Rules of origin are moreover considered as one type of so called "local content requirements," a measure type which is slowly being phased out internationally as host countries turn towards more open strategies towards FDI. Another trade related investment measure (TRIM) is export performance requirement where the MNC is obligated to export a certain percentage of output. It is a system that has been particularly successful regarding FDI in the automotive and electronics industries in developing and transition economies (Moran 1998, 82). In this way, the possibility of spillovers in the form of more advanced technology, export assistance, and training of local suppliers' workers would be significantly higher, as the affiliate is incorporated in the global sourcing strategy and where the parent company aims towards keeping high quality standards in the firm subsidiary.

Other ways to encourage MNCs to use local inputs in their production or to create other linkage formations could be through incentives aimed directly at a specific foreign affiliate.

This brings us back to Oman's (2000) arguments about incentive-based competition. It is however not certain that these incentives would have the desired effect on backward linkages and other spillovers, as it is usually required that the local suppliers uphold the necessary quality and efficiency level for the incentives to result in a long-lasting business solution (UNCTAD 2001, 171). Moreover, whichever incentive-measures are taken by the host country, it is essential to take into consideration the regulations under the TRIMs Agreement to avoid import substitution subsidies or the like.<sup>6</sup>

There are numerous other ways for the host government to assist in a more efficient linkage process and to help overcome such obstacles as high costs for MNCs to engage in local supplier relations and the difficulties for small domestic suppliers to negotiate with larger foreign firms. Information gaps and problems with the supplier and customer locating each other also need to be considered as well as strengthening the technology cooperation between the linked firms. These are often part of a broader more long-term linkage program where the host government takes specific steps in order to achieve the aspired effects on FDI. It is necessary to set the policy objectives, identify the specific measures to be taken, locate the target firms, and create an institutional and organizational system best fitting for the linkage program (UNCTAD 2001, 211 ff).

### **3.2 Minimizing the negative effects of FDI**

Although negative or non-existing spillovers already have been discussed, it is nevertheless important also to address more generally the negative effects that FDI, or more specifically the MNCs can cause. Problems that even today remain a concern for many investment-receiving countries center on the anticompetitive measures that might exist, such as restrictive business practices or abusive transfer pricing. Moreover, MNCs might avoid paying taxes or use redundant rent-seeking measures in order to benefit from economic and political decision-making in the host country (UNCTAD 2003, 88). One way in which governments can keep under control such harming actions is for instance through the creation of long-term investments where mutual trust and stronger relations with the foreign affiliates can in fact add to the production capacity of the entire economy. It is also important to have a sufficient regulatory system in place in order to prevent for instance tax avoidance as well as to smooth the process of prospective dispute settlements. Naturally, all the earlier mentioned public

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<sup>6</sup> Appendix II gives a summarizing overview of the TRIMs Agreement.

policies which create stronger linkages and other spillovers would ensure a more open cooperation as well as facilitate fair and efficient competition strategies.

### **3.3 Slovenia's public policy towards FDI inflows**

This section will take a closer look at the country of key interest for this qualitative study. As of the preparations for EU-membership, one of Slovenia's objectives has been to facilitate company creation. In the beginning of this century, clearer strategies on how to stimulate and benefit from FDI were presented for the first time. Some main policy measures were then laid out: 1. encourage FDI in the post-privatization period; 2. undertake the privatization process of state-owned companies for foreign investors; 3. promote FDI in the business services sector; and 4. stimulate investment in strategic industrial zones as a means of transfer of technology and knowledge. In these industrial zones appropriate infrastructure and a "transparent policy" is provided as an attempt to maximize allocation effects and industrial efficiency (IMAD 2001, 83). Much emphasis has been put on the creation of quality FDI and directing incentives towards investment which will have positive spillovers on job creation, technology transfer, and a more balanced regional development. It is also expected that fostering cooperation between foreign investors and Slovenian firms and institutions will result in additional knowledge exchange.<sup>7</sup>

#### **3.3.1 EU membership**

Kindleberger (1966) described a situation where economic integration can result in firms left outside the integrated area instead investing strategically in order to make up for lost export-markets, i.e. "investment creation." If regional integration instead leads to increased trade, changes in the regional production structure might cause regrouped investments within the integrated area. In this way, "investment diversion" can be the result (cited in Blomström and Kokko, 1997). The strategy towards EU membership that was the main objective of the Slovenian government during the 1990s outlined the shape of a handful of necessary fiscal, monetary and trade measures in reforming the economy (OECD 2002). The final steps of becoming a member in 2004 as well as joining the European Monetary Union (EMU) in 2007 were determining factors for facilitation of FDI, not only for investment from other members but it also implied access to a larger market for investors coming from outside of the EU, thus

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<sup>7</sup> Ministry of Economy, Republic of Slovenia,  
<http://www.mg.gov.si/en/splosno/novice/news/article/2159/5449/?cHash=05664d6531> (09-15-07)

the “investment creation.” But even earlier, when signing the Europe Agreement<sup>8</sup> in the late 1990s, Slovenia agreed to national treatment of firms coming from the rest of the EU-states. This was certainly one of the determining factors for MNCs which would otherwise see Slovenia as too small of a local investment region, with a population of merely two million. At the same time, Slovenia’s integration may result in an increased number of M&As or other types of strategic alliances in order for firms to be able to cope with growing competition. This would generate firm growth, higher R&D investment, and thus larger amounts of FDI to the local industry (Blomström and Kokko 1997, 13).

### **3.3.2 Trade liberalization**

It has earlier been mentioned that one factor determining the amount as well as the type of FDI is tariff levels applied in the host country. This has also been the case for Slovenia as the country applied the Common External Tariff (CET) when joining the EU. Consequently, Slovenia’s applied tariff rate, decreased from 12 percent in 1990 to 6.9 percent in 2004 (Damijan and Majcen 2003, 1381 and WTO 2007, 42). Here, it is expected that the inward flow of FDI in Slovenia has changed from market-seeking or so called “tariff-jumping” FDI to more export-oriented investment projects. Nonetheless, a precondition for investors to keep their focus on Slovenia instead of turning to other EU-members is that Slovenia has clear comparative and location advantages and is able to highlight them (Blomström and Kokko 1997, 11). These will be further touched upon in the following chapters.

### **3.3.3 Fiscal and financial incentives**

The corporate income tax rate in Slovenia is set at 23 percent and will be gradually lowered to stay at 20 percent from 2010 and on. There are however several *fiscal incentives* applied by the government in order to promote investment, foreign as well as local<sup>9</sup>. Firstly, the tax base for expenditure on R&D may be reduced and there is also an annual depreciation allowance on buildings and equipment ranging from 3 to 50 percent. Additionally, the payroll tax is to be abolished by 2009, taking some burden off high-income earners. This is in order to encourage firms to employ university graduates, thus creating a more high-skilled work force (Slovenia Business Week, 2006). Moreover, any donation made by the firm for humanitarian, scientific, educational or cultural purposes in Slovenia can also be tax reduced.

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<sup>8</sup> The Europe Agreement was the accession agreement between Slovenia and the EU, creating a free trade area between the parties during the period before EU-accession in 2004.

<sup>9</sup> The information on incentive policies of the Slovenian government is collected from the JAPTI, [www.investslovenia.org](http://www.investslovenia.org), if nothing else is stated.



Since the beginning of the century Slovenia has actively applied various *financial incentives* in order to minimize the cost of new entries into the regional industries. The “FDI Cost-Sharing Grant Scheme” applied by the government to reward foreign investment in industry, strategic services (customer contact centers, shared services centers etc) and R&D expenditures. Depending on the type of investment, the grant varies from EUR 2500 to EUR 20000 per new job created (Table 3.1). The main requirement for this aid is that the company has a minimum ten percent share of foreign ownership.

**Table 3.1 Slovenia’s FDI Cost-Sharing Grant Scheme for 2007**

	Investment value (million euro)	No. of new jobs created in three years time	Grant per new job created (euro)
<b>Manufacturing projects</b>	1	25	2 500 – 8 000
<b>Strategic services</b>	0.5	10	3 000 – 11 000
<b>R&amp;D</b>	0.5	5	7 500 – 20 000

Source: JAPTI – <http://www.investslovenia.org/incentives/financial/> (09-24-07)

### 3.3.4 Other FDI incentives and measures

In the past years, much attention has been given to further privatization in Slovenia. Most of the privatization in manufacturing industries has already been done but much of the public utilities and the financial sector remain to be privatized (OECD 2002, 50). A recent step taken towards larger liberalization is the buying out of major telecommunication providers in Slovenia. For instance, Austria’s *Mobilkom* is the sole owner of *SiMobil* since 2006<sup>10</sup>. Moreover, the state has in September 2007 opened a bid for a 49 percent share in *Telekom Slovenije*, one of the country’s largest telecommunication providers<sup>11</sup>. Furthermore, firms employing workers with disabilities or when employing students for work during a professional education, are eligible for reduced tax rates. Many universities also strive for increased cooperation with local companies as a way to connect students with potential future employers as well as to induce future research opportunities. Another incentive from the state focuses on lower unemployment rates, where local agencies offer training and retraining of employees for firms wishing to hire unemployed workers. Other local incentives include but are not limited to access to industrial locations, utility connections and local tax holidays.

<sup>10</sup> Mobilkom Austria, [www.mobilkomaustriagroup.com](http://www.mobilkomaustriagroup.com) (09-23-07)

<sup>11</sup> The Slovenia Times, 09-07-07, *Selling Telekom Slovenije*, [www.sloveniatimes.com](http://www.sloveniatimes.com) (09-23-07)

The Slovenian government also encourages business in so called Special Economic Zones (SEZs), which entitle firms to tax reductions and tax allowances (Ministry of Finance 2007, 33 ff). The conditions are specified in the Act on Special Economic Zones which was amended in February 2007. Companies operating in a SEZ can request tax concessions for initial investments and for job creation projects. For the moment there is only one SEZ in Slovenia, located in the Port of Koper and encompassing 55 companies (2006).<sup>12</sup> Nonetheless, the government has presented a “Resolution on National development Projects for the Period 2007-2003” (Government Office for Growth, 2006), where strategies for the development of several business and industrial zones are presented. The main objective of these zones will be to increase “inflows of development-promoting domestic and foreign investment” (p 21).

An important role in the promotion of Slovenia as a FDI target is also played by the Public Agency of the Republic of Slovenia for Entrepreneurship and Foreign Investments (JAPTI). The mission of the agency is to add to the competitiveness of the Slovenian economy by assisting businesses and investors with technical and financial means ([www.investslovenia.org](http://www.investslovenia.org), 10-05-07).

Summarizing the analysis of Slovenia’s policies towards inward FDI, the conclusion can be made that the State has learned to appreciate the gains to be collected from FDI, and has accordingly adjusted its development strategy to include a more active targeting of FDI. Such measures as increased privatization, lowered corporate tax levels, a cost-sharing grant scheme, and plans on additional EPZs should all attract reasonable amounts of new direct investment to Slovenia. If these policies actually have boosted investment inflows will be scrutinized in the following chapters.

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<sup>12</sup> Slovenia News, 11-19-06, *Govt Adopts Bill on Amending Economic Zones Act*, <http://www.ukom.gov.si/eng/slovenia/publications/slovenia-news/> (10-05-07)

## 4. FDI in Slovenia

The Slovenian government has begun to promote FDI more extensively as the importance of investment inflows for the overall economic growth in the country has become more evident. This chapter depicts the patterns of FDI inflows, starting with a presentation of policies during the first decade of independence. This is crucial in order to better understand the actual stocks and inflow patterns of FDI. The chapter continues by presenting data on FDI volume and origin for the years 1994-2006, with variations depending on data availability. These findings are then summarized and analyzed. Conclusively, Slovenia's comparative advantages are put forth to give a better understanding of why investors choose Slovenia over other regions.

### 4.1 Opening up to investment

As a republic in the Socialist Federative Republic of Yugoslavia (SFRY), Slovenia was a part of an economic system where enterprises were independent from the state and capital owners but power over the firms was instead given to the working class, with principles of social ownership and self-management. With commercial banking as well as monetary and fiscal policies in place early on in SFR Yugoslavia's development, once Slovenia had reached independence in 1991, the country could experience a smoother transition towards a full-fledged market economy than most of the other former socialist states in Central and Eastern Europe (CEE) (OECD 2002, 9).

The mass privatization of firms during the first years of independence took mainly the form of internal buy-outs by workers and managers. Trade was liberalized gradually, all in preparation for membership in the WTO and ultimately the EU. Unlike the earlier Yugoslav emphasis on import substitution, the Slovenian economy started relying on export oriented strategies (Damijan and Majcen 2003, 2375).<sup>13</sup> Nonetheless, the internal buy-outs and transfer of ownership to public funds resulted in much of the economy turning to state ownership. At the same time, several other factors limited foreign partaking in the privatization process, i.e. a two-year freeze on share transfers and other capital controls, restrictions on investment in the banking and insurance sectors, attaching shares to workers' associations, and an insignificant role of the stock market (WTO 2002, 56 and Simoneti et al 2004, 233). This culminated in a

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<sup>13</sup> For a more detailed study on the transition process in Slovenia as well as the economic integration with the EU, see for instance WTO's *Trade Policy Review on Slovenia* (2002).

second privatization phase starting in 1999 with the signing of the Europe Agreement (OECD 2002, 53). These active policies to promote FDI (chapter 3) resulted in extensive foreign acquisitions of large state-owned companies mainly in the areas of finance, telecommunications, and key manufacturing sectors.

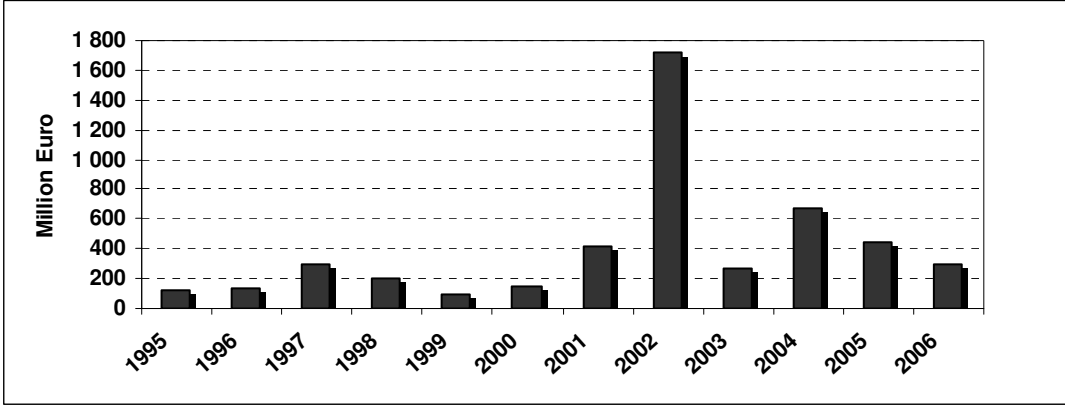
## **4.2 FDI in volume and origin**

As the rest of this chapter will show, inward direct investments in Slovenia have not been as immense as in many of the other new EU-members. Only 5.1 percent of Slovenian companies have more than 10 percent foreign ownership (Bank of Slovenia 2007, 21). Nonetheless, the actual role of these firms in the Slovenian economy is much more significant, as they in 2005 made up 16 percent of capital, 18 percent of assets, and almost 14 percent of the working force in the whole corporate sector. 22 percent of all operating profit in the economy came from firms with FDI and they also presented higher profit per employee in all but the sector of financial intermediation (Bank of Slovenia 2007, 22). What is more, FDI in Slovenia in 2005 accounted for almost 37 percent of exported goods and 36 percent of the import of goods (Bank of Slovenia 2007, 21). These facts not only add to the importance of further promotion of FDI in Slovenia but also give a motive for more scrutinized analysis of the inward FDI in the economy.

### **4.2.1 Inflows and stocks of FDI**

Since independence, Slovenia has managed to stabilize the economy and focus on the long-term objective of EU-membership. The efficient stabilization of the economy started attracting investors, with the country's FDI stock nearly tripling from 1994 (EUR 1 080 million) to 2000 (EUR 3 110 million) once the Europe Agreement was signed. Except of a smaller decrease in 2001 Slovenia has experienced an overall steady growth in FDI stocks, with numbers reaching EUR 6 775 million in 2006.

**Figure 4.1 FDI inflows into Slovenia 1995-2006**

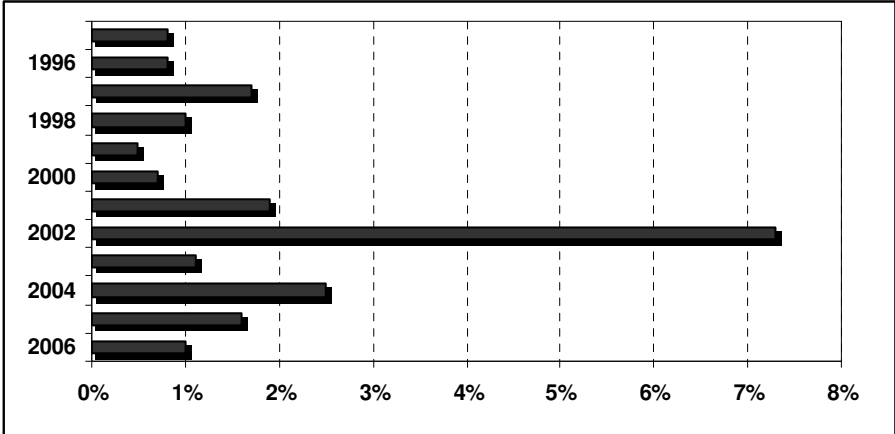


Source: Bank of Slovenia

The annual inflows of FDI in Slovenia also saw a strong upsurge during the first years of independence only to experience a decrease in FDI inflows at the end of the last decade (Figure 4.1). Once the second privatization phase got under way, inflows of direct investment more than tripled from 2000 to 2001. Slovenia became rapidly a more attractive target for FDI, which could be clearly seen in 2002 as inflows soared to EUR 1 730 million.

When considering the scale of FDI inflows, it is important not only to take into account real inflows but also to put these numbers in relation to the GDP of the country. This way, a clearer picture of the actual importance of inward FDI to the host economy can be presented.

**Figure 4.2 Annual FDI/GDP ratio 1995-2006, percent**

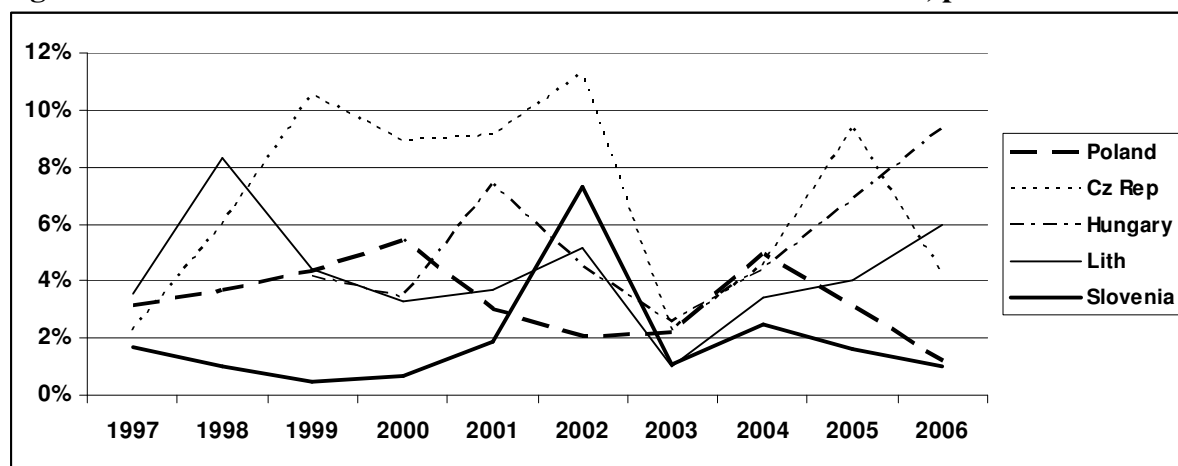


Source: Bank of Slovenia, author’s calculations

Figure 4.2 shows that the overall impact of inward FDI on Slovenia’s GDP has remained under two percent for all except two years under the measured eleven-year period. The substantial increase in 2001 and 2002 can mainly be ascribed to a number of large

privatization projects in Slovenia and several new MNCs entering the market (Silva-Jáuregui 2004, 123). Some of the most mention worthy are the privatization of Slovenia's largest bank, *Nova Ljubljanska Banka* and the purchase of 39 percent of its shares by EBRD and the Belgian banking group KBC, followed by the acquisition of the pharmaceutical firm Lek by the Swiss company Novartis and the purchase of Simobil by Austria's Mobilkom (Silva-Jáuregui 2004, 124). The direct investment inflows after 2002 have fluctuated, finally settling on one percent of GDP at the end of last year.

**Figure 4.3 Annual FDI/GDP ratio in new EU25 members 1997-2006, percent**



Source: Bank of Slovenia and Eurostat, author's calculations

When putting Slovenia's inward FDI in perspective with investment inflows of other countries the economy's lower FDI levels become even more evident. Figure 4.3 illustrates FDI inflows as percentage of GDP for five of the new EU-members.<sup>14</sup> The selected countries have shown varying results of inflows, with strong initial growth and a significant decline by the year 2003. The values in the Czech Republic, Hungary, and Lithuania are higher in 2006 than initially during the measured period, and although Poland has experienced decreasing impacts of FDI, it still remains on a level above the one in Slovenia. The average FDI/GDP ratio for all ten new members in the EU25 was 6.5 percent in 2006 (Appendix III).

#### 4.2.2 Origin of FDI

Turning to the distribution of FDI between countries of origin, a clear trend towards dominant FDI from EU-members can be seen in Slovenia, with an increased share of total FDI from 62 to almost 78 percent in the period 1994-2006. The interest from the EU-members to invest in

<sup>14</sup> The four countries excluding Slovenia have been chosen based on variation in annual FDI/GDP ratio and accessibility of data.

Slovenia has risen relative to that of countries outside of the integrated region, as Slovenia has adapted its economic and structural policies and business practices to those of the EU.

**Table 4.1 Inward FDI by country and share of total FDI stock, 1994 and 2006**

Country	1994		2006	
	Mio €	%	Mio €	%
Austria	242	22.4	2 187.7	32.3
Switzerland	52.3	4.8	933.4	13.8
Netherlands	9	0.8	618.8	9.1
France	125.7	11.6	588.1	8.7
Germany	160	14.8	537.2	7.9
Italy	111.1	10.3	374.3	5.5
Luxembourg	0.2	0.0	2953	4.4
Croatia	334.1	30.9	278,0	4.1
Belgium	4	0.4	248,5	3.7
USA	9.9	0.9	146.7	2.2
United Kingdom	4.5	0.4	126.8	1.9
Denmark	13.5	1.2	95.4	1.4
Czech Republic	0.1	0.0	88.0	1.3
Australia	0	0.0	42.6	0.6
Liechtenstein	1.4	0.1	35.5	0.5
RoW	13	1.2	178.6	2.6
<b>Total</b>	<b>1 080.8</b>	<b>100.0</b>	<b>6 774.9</b>	<b>100.0</b>
<b>EU25</b>	<b>670</b>	<b>62,0</b>	<b>5 256.90</b>	<b>77.6</b>
<b>FYR*</b>	<b>338.2</b>	<b>31.3</b>	<b>293.8</b>	<b>5.6</b>

Source: Bank of Slovenia, author's calculations

\* Bosnia and Herzegovina, Croatia, FYR Macedonia, Montenegro, and Serbia

Slovenia's by far largest foreign investor in 2006 was Austria, a position that the country has held since 1995. Austria is followed by Switzerland, the Netherlands, France and Germany. The country with the largest decline of direct investment in Slovenia is Croatia, decreasing its share of total FDI stock by nearly 27 percentage points during the measured period, as well as decreasing its overall FDI stock.

#### 4.2.3 FDI distribution by activity

In this section Slovenia's inward FDI is analyzed by activity in order to localize the type of FDI coming into the country. Interesting is to see if investments have remained in the same sectors or if Slovenia has redefined its comparative advantages after the extensive economic restructuring and privatization that has take place in recent years. As theoretical analyses have shown, the type of FDI can also be divided into market-seeking or export oriented investments. Seeing as services are usually less movable over borders, one can assume that

more services-oriented direct investments are naturally market-seeking. At the same time, the presence of more export-seeking FDI projects in Slovenia could be expected when considering the country's small local market.

**Table 4.2 Inward FDI by activity and share of total FDI stock, 1994-2006, percent**

	1994	2002	2006
<b>MANUFACTURE</b>	<b>42.5</b>	<b>44.0</b>	<b>37.1</b>
Chemicals & chemical products	6.1	13.7	13.4
Rubber & plastic products	1.1	5.1	4.8
Motor vehicles, trailers etc.	10.7	1.3	4.0
Pulp, paper & paper products	9.1	6.2	3.8
Machinery & equipment nec.	6.2	4.0	2.9
Other non-metal mineral prods	2.0	3.2	2.4
<b>SERVICES</b>	<b>54.7</b>	<b>54.3</b>	<b>62.5</b>
Financial intermediation, not insurances	6.4	17.9	19.3
Other business activities	6.9	13.0	11.3
Wholesale, commission, not motors	6.8	8.2	8.3
Sale, repair etc. motors; fuel	5.2	3.9	4.5
Real estate activities	0.1	1.4	3.8
Retail trade, not motors; repairs	2.9	2.1	3.7
Electricity, gas, steam & hot water	22.4	0.6	3.7
Post and telecommunications	0.1	3.2	3.2
<b>AGRICULTURE, MINING, AND QUARRYING</b>	<b>0.0</b>	<b>0.0</b>	<b>0.3</b>

Source: Bank of Slovenia (2004) and <http://www.bsi.si/en/financial-data.asp?MapaId=330>, author's calculations

Table 4.2 presents aggregated data in the 15 sectors with the largest shares of FDI investment for three years during the period 1994-2006.<sup>15</sup> The measured period illustrates a relatively strong move towards services activities, in particular in the sectors of financial intermediation and other business activities. The latter contains sub-divisions in legal and accounting activities, technical testing, advertising, and labor recruitment. The earlier important sector of electricity, gas, steam, and hot water has seen a heavy decline in importance in the overall FDI stock during the eleven-year period. In the manufacturing divisions, there has been a significant shift from pulp and paper products and motor vehicles towards chemicals and chemical products. Nonetheless, these sectors still remain among the most important ones for Slovenia's inward FDI.

<sup>15</sup> The Bank of Slovenia uses the EU classification system, NACE Rev. 1.1 for its aggregated data, with a total number of 46 sectors. The full list for the scrutinized years can be found in Appendix IV.



**Table 4.3 Top 10 investing firms in Slovenia by turnover, 2006**

<b>Company</b>	<b>Sector</b>	<b>Investing country</b>
<b>Revoz D.D. (Renault)</b>	Automotives	France
<b>Lek D.D. (Novartis)</b>	Pharmaceuticals & Chemicals	Switzerland
<b>SPAR Slovenija D.O.O.</b>	Retail trade	Switzerland
<b>SAVA Tires D.O.O. (Goodyear)</b>	Pharmaceuticals & Chemicals	Luxembourg
<b>Iskratele D.O.O. (Siemens)</b>	Electro- components	Germany
<b>Boxmark Leather D.O.O.</b>	Textiles and leather	Switzerland
<b>Johnson Controls-NTU D.O.O.</b>	Automotives	Germany
<b>BSH Hisni aparati D.O.O. (Bosch-Siemens)</b>	Electro- components	Germany
<b>Henkel Slovenija D.O.O.</b>	Pharmaceuticals & Chemicals	Austria
<b>TCG Unitech LTH-OL D.O.O.</b>	Automotives	Austria

Source: JAPTI, unpublished material

Another way of analyzing FDI by industry is by looking at the actual firms with direct investments operating in Slovenia. The largest ten enterprises depicted in Table 4.3 are sorted by turnover and are active in the secondary (industrial) and tertiary (services) sectors, where the dominating industries are automotives as well as pharmaceuticals and chemicals. Of the ten firms, nine are fully owned by the investing company, while Siemens holds a 48 percent share in Iskratele. Although a majority of the 2 988 FDI firms operating in Slovenia in 2005 were small and medium enterprises (SMEs) (Bank of Slovenia 2007, 17), it is still a smaller group of large firms who stand for most of the direct investment (OECD 2002, 18). The ten investment projects presented in Table 4.3 accounted for half of the revenues in 2006, while the largest 25 projects made up 70 percent of total revenues for FDI firms (JAPTI, unpublished material).

As to FDI operations in the banking sector, the largest Slovenian banks with significant or full foreign ownership are Banka Koper (Italy), Hypo Alpe-Adria-Bank d.d. (Austria), NLB d.d. (Belgium), Raiffeisen Krekova Banka d.d. (Austria), and SKB Banka d.d. (France).<sup>16</sup>

<sup>16</sup> The size of foreign owned banks based on turnover were not available for this study.

### **4.3 Discussion on Slovenia's inward FDI**

The statistical data on FDI flows into Slovenia presented above shows that although the country has seen extensive privatizations and underwent significant reforms in investment promotion, the levels of inward FDI have remained relatively low in relation to the above average healthy economic environment in the country. Also when looking at the comparative numbers on FDI/GDP ratios in the new EU member states, Slovenia scores very low. These values confirm that Slovenia, in spite of being one of the wealthiest new EU-members, has not managed to attract foreign investment to the same extent as the other CEE economies. Except of the earlier discussed internal buy-outs, some other plausible reasons for this weak FDI development are slow restructuring and weak strategic planning in the privatized firms as well as a relatively small local market. Other negative impacts have come from high administrative barriers in establishing and developing business activities, difficulties in finding industrial locations, high labor costs in comparison to other regions in CEE, and a relatively immobile labor force (Simoneti et al 2004, 236).

As regards to the FDI inflows divided by country of origin, there has been a clear trend of investment from the EU, which is an indication of enhanced intra-regional FDI inflows. The major explanations for Austria, Switzerland, the Netherlands, France, and Germany being the main investors are geographical proximity and traditionally close cooperation with the economies. The reorientation of FDI inflows from the EU has mainly been at the expense of the share of FDI coming from Croatia. One explanation for the declined FDI flows can be that Croatian firms have faced increased competition in Slovenia, focusing instead on other countries and better internalizing their comparative advantages.

FDI stocks when analyzed by economic activity show a strengthening position for investment in the services sector, particularly financial intermediation. There are two factors to consider in the shift towards services in Slovenia's inward FDI. First, there were earlier relatively more barriers to investment in services and public utilities in comparison to those in manufacturing sectors (OECD 2002, 36). Privatization of these activities has gotten under way in recent years, causing an upsurge in FDI projects in services, in particular banking activities. A second factor is the active strategic policies laid out by the Slovenian government to promote FDI in business services (chapter 3). When considering the motor vehicles and trailers division, one should keep in mind that the services of sale and repair of motors as well as fuel

are directly connected to the manufacturing of motor vehicles. Including this sector in the overall industry of automotives gives this division even more importance in Slovenian direct investment inflows.<sup>17</sup>

#### **4.4 The competitive edge – What makes Slovenia the better choice?**

As illustrated with the statistical analysis of Slovenia's inward FDI, the public policies undertaken by the government have shown positive results on direct investment inflows. The heavy upsurge in FDI in 2002 was bound to slow down in the following years, stabilizing at a higher level than was recorded during the first years after independence. It can also be expected that an uprising trend in inward investment will be evident in the years to come, as the State moves forward in its development and liberalization policies. Plans for additional tax reductions and improvements in business facilitation, i.e. dealing with licenses and registering property (World Bank, 2007) will certainly encourage more multinational firms to focus on the Slovenian market. Nonetheless, incentives cannot alone motivate firms to invest in a country, but there must be economic determinants which will give the FDI receiving economy an edge – a comparative advantage – over other candidates. Going back to the OLI-paradigm presented in chapter 2, Slovenia's location advantages are now discussed.

##### **4.4.1 Geographic location**

Slovenia lies in the heart of Europe in close geographic and economic relations to its Western European neighbors as well as the CEE states. The country's central location and access to the Adriatic Sea implies low transportation costs in the cases where investment comes in the form of vertical FDI. It has a traditionally close connection to Austria, being once a part of the Habsburg monarchy. More importantly, Slovenia's proximity to Southeastern Europe and particularly its understanding of the Balkan states is crucial. Being a former Yugoslav republic with cultural and economic knowledge of the economies as well as having significant outward FDI to this region (Bank of Slovenia 2007, 27), Slovenia has a strong comparative advantage as these states advance in their integration process with the European Community.

##### **4.4.2 Production factor availability**

Although having relatively higher labor costs in comparison to other CEE states (Eurostat), Slovenia makes up for this by having a highly skilled workforce. Some of the strongest

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<sup>17</sup> To be able to in detail investigate connections – and plausible spillovers – between sectors, more disaggregated data on the various activities is needed. Such data sets for Slovenia are not available to date.

motives for foreign firms to invest in Slovenia are in fact the country's technology and know-how followed by high quality of labor (OECD 2002, 22). It is one of the main comparative advantages of Slovenia, as can be confirmed in Table 4.3, where eight out of the ten largest firms with FDI are in such high value-added sectors as automotives, pharmaceuticals, and electro-components. Overall productivity in Slovenia in 2006 outplayed many of the EU-states, for instance Hungary, the Czech Republic, Portugal, and Slovakia ([www.investslovenia.org](http://www.investslovenia.org), 09-28-07).

#### **4.4.3 EU integration**

Blomström and Kokko (1997) discuss the changes in FDI flows once a country engages in a regional integration agreement. They argue that the reduction of trade barriers and harmonization of trade policies would induce increased FDI flows as foreign firms would be enabled to work more freely and efficiently across borders (p 8). Slovenia has in fact created a more predictable and credible environment for investors by accepting regulations in trade and investment policies harmonized with the ones of the EU as well as creating free movement not only for goods and services but also for capital and labor. Moreover, by taking the ultimate step towards full integration with the EU i.e. joining the EMU, Slovenia can offer foreign firms lower transaction costs and reduced uncertainty regarding the exchange rate.

#### **4.4.4 General investment climate**

Such economic conditions as local governance and other institutional quality measures are also expected to effect investment decisions (Lipsey 2006, 11). Slovenia has in the past years presented both high competitiveness rankings as well as governance scores, almost uninterruptedly in the top rankings among the new EU-members (Lipsey 2006, 12). Making the double transition from a socialist and federal state to a national market economy, Slovenia has managed to reach high levels of macroeconomic stability, decreasing inflation rates, and stabilizing interest rates by introducing the Euro. Furthermore, the country has been swift in improving infrastructure, implementing good transport and communication connections between trade and industrial centers ([www.investslovenia.org](http://www.investslovenia.org), 09-28-07).

The investment climate can also be measured by the ease of doing business. The World Bank has developed a ranking method based on such factors as starting and closing a business, employing workers, and protecting investors.

**Table 4.4 Doing business in CEE, Rankings in Eastern Europe and Central Asia 1-28**

	<b>Ease of doing business</b>	<b>Starting a business</b>	<b>Dealing with licenses</b>	<b>Employing workers</b>	<b>Protecting investors</b>	<b>Enforcing contracts</b>	<b>Closing a business</b>
Lithuania	4	11	4	21	13	5	1
Hungary	7	14	10	12	22	2	7
Slovenia	10	24	5	28	1	22	2
Czech Republic	11	18	9	5	13	25	22
Poland	14	26	21	10	3	20	17

Source: World Bank, *Economy Rankings, Doing Business 2008*

The estimates for the ease of doing business in selected CEE states are presented in Table 4.4. Slovenia shows an overall high ranking among Eastern European and Central Asian states, scoring exceptionally high in protecting investors, closing a business, and dealing with licenses. However, there are still areas where improvements can be made, in particular starting a business, enforcing contracts, and employing workers. The last can be expected to be higher in the following years, as the Slovenian government has started to simplify employment procedures. A first step has been taken by making it easier to hire high-skilled workers.

This chapter has shown that Slovenia has much potential to increase its relatively low levels of FDI. The country encompasses such competitive qualities as its geographical location, a stable and prosperous macroeconomic outlook, high quality workforce, etc. More generally, this thesis aims to explore the spillover effects arising from FDI for the receiving country as well as the optimal ways that the host government can encourage investment and make sure that the economy benefits to an as large extent as possible. By carrying out a qualitative study on Slovenia's FDI inflows and applying the theory to a specific investment case, the aim is to gain a better understanding of how spillovers from FDI can be optimized. The case study is portrayed in the next chapter.

## **5. FDI in the automotive industry**

The strong upsurge of FDI in CEE, and more specifically in the automotive sector serves as an example of the large potential that this region has to offer for foreign investors. At the same time, it can be expected that the competition between the countries' governments will increase in order to attract MNCs and secure long-term investments. The important role that Renault plays in Slovenia and the recent recognition from the government of the firm's positive impact on the economy is therefore especially interesting to study. First, the automotive sector and FDI in CEE are described, followed by an overview of automotive manufacturing in Slovenia. The chapter then continues by looking at the development of the Renault subsidiary, Revoz in Novo mesto and providing a qualitative overview of benefits expected to occur from the firm's presence and from the recent production expansion.

### **5.1 The automotive industry in Europe**

#### **5.1.1 The trend towards CEE**

Since the fall of the Iron Curtain in the beginning of the last decade and since making the transition from socialist countries to market economies, the CEE states have increased their own production volumes as well as managed to attract significant amounts of FDI. One of the most attractive sectors for MNCs in CEE is the automotive industry. The manufacture of cars in the new EU member states reached more than 1.6 million vehicles in 2005 which is 9.5 percent of the production in EU25 (UNCTAD 2006, 91). The leading producers are the Czech Republic, Poland, Hungary and Slovakia, however large manufacture plants can also be found in the Estonia, Latvia, Lithuania, and Slovenia. Taken as a whole, the industry is dominated by foreign firms, as they make up 70 percent of total employment in the sector and account for up to eleven percent of the individual countries' total manufacturing value added (European Communities 2004, 156). A majority share of these manufacturers is held by Western European car makers, which are moving certain models and parts of production processes to CEE. This is an indication of Kindleberger's "investment diversion" process as a result of increased trade between the member states (chapter 3). Many of the new members had their own national car makers before 1990,<sup>18</sup> most of which either ceased to exist or were taken over by Western car producers. Domestic as well as foreign investment is however not

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<sup>18</sup> *FSM* and *FSO* in Poland, *Skoda* in former Czechoslovakia, *Industrije Motornih Vozil* and *Zastava Yugo Automobili* in former Yugoslavia along with *Dacia* and *Oltcit* in Romania (Tulder and Ruigrok 1998, 3).

only limited to final car manufacture but in the past ten years a general trend towards higher specialization in the motor vehicle industry, including the automotives component sector, is evident for many of the new members (European Communities 2007, 38). This could be expected, seeing as the presence of car making firms enables good connections and closeness with suppliers.

### **5.1.2 Why the CEE states?**

One of the major motives of firms investing in CEE is the central position and access to the large regional market. Although main FDI projects come from European manufacturers, an increasing number of Asian and American MNCs are moving production to the region, mainly to exploit a growing local market but also to avoid EU-tariffs and thus directly have access the whole EU-region (European Communities 2004, 190 and 233). The investment is thus not only limited to “investment diversion” but also “investment creation.” Seeing as export sales in the region ranged from 86 to 98 percent of total sales, and considering that the capacity of automotive manufacturers in the new member states was estimated to more than 2 million passenger cars in 2006 (European Communities 2004, 190), the conclusion can be made that FDI is highly export-oriented. Other drives for car manufacturers in the CEE economies come from low labor costs, strong economic growth and a skilled workforce (UNCTAD 2006, 91).

The new EU-members offer various incentives to foreign investors in order to attract the increasing number of foreign firms interested in investing in the region. The tax environment, for instance is more beneficial than in the EU15, where the eight new CEE members of the EU25 have an average corporate income tax rate of 21 percent, compared to 29 percent in the EU15 (European Communities 2007a, 92). There has also been a trend towards the involvement of investment promotion agencies (IPAs) in active targeting towards FDI (UNCTAD 2005, 213). Moreover, various types of export processing zones are being established in these countries (Johansson 2002, 389).<sup>19</sup>

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<sup>19</sup> EPZ in the Czech Republic: [www.graddo.com](http://www.graddo.com)  
EPZs in Poland: <http://www.paiz.gov.pl/index/?id=a3f390d88e4c41f2747bfa2f1b5f87db>  
EPZs in Slovenia: Government Office for Growth (2006)

## 5.2 The automotive industry in Slovenia

The number of firms producing cars and car parts in Slovenia amounted to 185 companies in 2005. A total number of 24 500 people were employed in this sector and the revenue was EUR 1.2 billion (www.investslovenia.org, 10-03-07). Key products are *inter alia* car body parts, seats and seat components, materials for interior furnishing, components for braking systems as well as mechanical and electric components for engines. Of the total production value in 2005, 90 percent was exported, where the key markets were Germany, France, Italy, Austria, the United Kingdom, USA, and Spain (www.investslovenia.org, 10-03-07). The automotive supply industry and the car production together represent 10 percent of Slovenian total exports and 6 percent of GDP (www.sloveniapartner.com, 10-03-07). Moreover, the productivity in the industry is very high, with an average value-added per employee of EUR 37 500 in the most successful firms (www.investslovenia.org, 10-03-07). The strengthening of the business position of Slovenian automotive suppliers comes to a great extent from the work done within the business interest association *Automotive Cluster of Slovenia* (ACS), where an increasing emphasis is laid on internalization of firm advantages and R&D (ACS 2005, 16).

### Box 5.1 The Automotive Cluster of Slovenia

- The business interest association ACS, Automotive Cluster of Slovenia was established in 2001 and includes 54 members of which 47 are companies and 7 are R&D institutions (December, 2005).
- Some large Slovenian and foreign firms included in the association are Cimos d.d., Goodyear d.o.o., Iskra d.o.o., Johnson Controls – NTU d.o.o., and Unior d.d.
- The main activities of the ACS include the creation of new business opportunities for its members, further development of employee skills, and the overall strengthening of the members' competitiveness, locally as well as internationally.
- Promotion is aimed mainly at car manufacturers and system suppliers in the automotive industry.
- Teamwork with and assistance to clusters in the developing stage in other countries (*inter alia* Croatia and Serbia) is also carried out by the ACS as a way to strengthen regional competitiveness as well as increase the network for local firms.

Source: ACS (2004) and (2005)

## 5.3 Renault in Slovenia – The Revoz plant

The French car maker Renault started its production in SFR Yugoslavia in the form of a strategic partnership with the local motor vehicle producer *Industrije Motornih Vozil* (IMV) in 1972.<sup>20</sup> The two firms signed a cooperation agreement where the model Renault 4 went into production at the IMV site in Novo mesto. During the 1970s two other Renault models were manufactured at the plant, and the years were characterized by extensive investments in new production methods and improved infrastructure. First in 1989 is the IMV car production

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<sup>20</sup> The background information on Renault in Slovenia is collected from www.revoz.si (10-03-07), if nothing else is stated.



transformed into the Revoz company, a manufacturer as well as commercial representative of Renault vehicles. In 1991 Revoz was turned into a joint stock company between Renault, the Slovenian state, and NLB, with the Renault share gradually increasing from the initial 20.2 percent to full ownership in 2003. Meanwhile, the production of all models but the Clio was ended in Novo mesto and great investments were made in the introduction of the Clio II which remained the sole model produced in Slovenia until 2007. The production includes sheet metal shaping, assembly, welding, and painting. During the period 1974-2005, the assembled volume in the Revoz plant exceeded 2.2 million vehicles, and the development of the annual volume, in particular in the last years has been significantly stronger (Table 5.1). Apart from being the only Renault manufacturer of the Clio II for the European market, much was also invested in starting up production of the new Twingo model in the Revoz plant as of January 2007.<sup>21</sup> It is estimated that production of the two models will exceed more than 200 000 cars per year once the manufacturing has gotten under way (ACS 2004, 11). Additionally to car manufacturing as its key business, Renault has during the past years introduced a logistics outsourcing system through the “Parts & Accessories Division,” focusing on meeting the high standard requirements of regional car plants which apply the principle of just-in-time delivery. Thus, the spare parts normally provided by distribution centers in France will instead be outsourced to local warehouses in Renault’s key growth regions. One of these regions is Slovenia, where the work of building a warehouse for parts and accessories has been initiated (Renault 2006, 44).

Revoz has for several years held the position as Slovenia’s largest foreign investor and is today also its largest exporter, with 95 percent of the produced volume in 2006 being sold abroad. 10 percent of the exports reach outside of Europe, while the main export markets of Revoz inside of the European borders are found in France, Germany, and Italy (interview 10-05-07).

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<sup>21</sup> Slovenia Business Week no. 10, [http://www.sloveniapartner.com/news\\_archive.asp?ID=1597&tn=1](http://www.sloveniapartner.com/news_archive.asp?ID=1597&tn=1) (10-03-07)

**Table 5.1 Operations in Revoz, 2003-2007**

	<b>Production value (units)</b>	<b>Net sales (million EUR)</b>	<b>Net profit (million EUR)</b>
<b>2003</b>	118 200	766.96	8.38
<b>2004</b>	131 761	882.78	18.42
<b>2005</b>	177 945	1 151.33	36.79
<b>2006</b>	152 987	1 008.16	26.64
<b>2007*</b>	92 729	n.a.	n.a.

Source: Renault Atlas (September 2007), JAPTI unpublished material, www.revoz.si. Author's calculations

\* (Jan – June, 2007)

One additional important step in the development of Revoz was the separation of the firm's industrial and commercial activities. In 2002, the commercial branch Renault Slovenia was founded, while Revoz continued as the vehicle manufacturer.

### **5.3.1 Renault's motives to invest**

Renault entered into cooperation with IMV motivated by access to the large Yugoslav market, and with low labor costs and the access to a skilled workforce as additional motives (OECD 2002, 24). Thus, a clear market-seeking objective was the initial characteristic of Renault's investment. At the same time Renault had production knowledge and internalization advantages which gave the company the confidence needed to compete with Yugo, the other local car manufacturer (interview 10-05-07). After the disintegration of SFR Yugoslavia, Renault lost great shares of its initial market, and had to make large reorientations in the company's FDI strategy in the region. From the earlier market-seeking form of FDI, where Renault focused on access to the local economy, the company (by this time with the Revoz plant in operation) initiated the reorientation of sales from Novo mesto mainly towards the Western European markets.

What was then Renault's motivation to stay in Slovenia, and not instead place its production in other countries where larger local markets could be considered as more attractive than Slovenia's suddenly decreased market? First of all, the factor cost advantages of manufacturing in Slovenia were highly advantageous in comparison to production in for instance France (OECD 2002, 25). Additionally, relocating to another CEE state where factor costs were relatively lower would bring new challenges when facing competition from the increasing number of western car manufacturers in CEE. At the same time, Renault would

lose the comparative advantage and acquired knowledge of the local market as well as the access to a high-skilled workforce, superior to that of many of the other CEE economies.

### **5.3.2 State incentives**

Just as all other foreign investors in Slovenia, Renault did not enjoy any “special treatment” from the Slovenian government, as the state did not have an active investment promoting role during the 1990s (interview 10-05-07). Also during the time of SFR Yugoslavia there are no known incentives aimed towards FDI. It is instead during the past years that the State has restated its policies towards investment incentives, mainly by implementing the FDI Cost Sharing Grant Scheme and making it more profitable for companies to hire high-skilled workers, but also through several other fiscal and financial incentives (chapter 3).

The largest impact that the new FDI strategy has had on Revoz’ activities has been the State’s direct involvement in expanding production to also include the new Twingo model. When production plans for the Twingo started in the beginning of this decade, Renault turned to the Slovenian government for financial assistance of the project (interview 10-05-07). The State agreed to cover 10 percent of the investment costs, presuming that a certain number of new jobs were to be created as production increased and that 30 percent of the firm network supplying parts for the Twingo was required to be local companies. This was to be a large increase from the 15 percent local content being used for the Clio II. Another difference in the overall supplier source is that the parts for the Twingo are mainly coming from suppliers from CEE. Also for the Clio II is this share rapidly increasing, indicating a shift from suppliers in France and Spain towards *inter alia* Slovakia, the Czech Republic, and Slovenian local providers (interview 10-05-07).

### **5.3.3 The effects from Renault’s presence in Slovenia**

The questions asked in this thesis are how the Slovenian economy is benefiting from FDI and how the positive spillover effects coming from FDI are being optimized. An attempt to answer the questions comes through a qualitative analysis of the State’s involvement in the recent expansion of Revoz. What are the direct effects of FDI? Are there spillovers coming from Renault’s presence, and are they being optimized?

Focusing first on the direct effects and *job creation*, Revoz is one of four foreign owned firms in Slovenia with more than 2 000 employees (the other three are Lek d.d., NLB d.d., and

SPAR Slovenija d.o.o.) (JAPTI, unpublished material), indicating that the contribution to the local economy in terms of job opportunities is significant. The number of employees is approaching 3 000, an upsurge from approximately 2 000 in the beginning of this decade (interview 10-05-07). This rise in employment can mainly be accounted to the Twingo project which in itself created roughly 700 new jobs in the Revoz plant (ACS 2004, 11). All but 350 of the workers are locally employed, whereas the rest are temporary employees sourced from neighboring countries, mainly Slovakia and Bulgaria (interview 10-05-07).

**Table 5.2 Ratios of wages in Revoz, EUR, 2006**

Value added per employee	35 783
Net profit per employee	10 336
Average monthly wage	1 125
<i>Average monthly wage in the manufacturing sector</i>	<i>1 050</i>

Source: JAPTI, unpublished material and SORS

As for the *wage levels*, these were averaging EUR 1 125 per month in 2006 (JAPTI, unpublished material), a wage level in line with the Slovenian average, yet higher than the average monthly wage in the manufacturing sector (Table 5.2). This confirms earlier empirical research which shows that foreign firms on average pay higher wages than local companies (Lipsey and Sjöholm, 2004 and Pavlinek, 2004).

One of the earlier mentioned channels through which spillovers can reach outside of the MNC is through *backward linkages* and *technology transfer* to suppliers, i.e. production assistance, creation of indirect jobs, training of workers, and consequently an increase in product quality and overall productivity. As the level of local content in the production in Revoz increases, so do the chances for Slovenian suppliers and the economy as a whole to benefit from spillovers. To begin with, the specific situation of Revoz and Slovenian suppliers fulfill many of the characteristics required for linkages to occur. Revoz was created as a M&A and was not a pure greenfield investment, implicating that the local connection was there early on. Considering also the fact that Renault has been operating in Slovenia for over 30 years further amplifies local firms’ knowledge of Revoz and increases their skills. Moreover, as Slovenia already has a high-skilled workforce, it can be assumed that the technology gap between the local suppliers and Revoz is not too wide and that the absorptive capacities of local firms are good enough for the companies to be able to enjoy plausible spillover effects. In addition, the extensive work that Revoz is doing in keeping a strong connection with suppliers will

certainly add to the backward linkage effects. For instance, in the initiation phase of the Twingo production, many seminars and conventions were held with important suppliers in order to keep them up-to-date and for suppliers to be able to produce and supply efficiently, at the quantity and quality levels set by Revoz (interview 10-05-07). Revoz has a division where suppliers can turn directly with questions, and where meetings can be set up. A general open policy and much investment in productivity has been the strategy of Revoz in recent years, both regarding own workers and production as well as the productivity level of suppliers (interview 10-05-07 and [www.revoz.si](http://www.revoz.si) 10-07-07). The policy of cooperation with suppliers is a general one of the Renault group, where for instance a special website is dedicated to the support of suppliers and their role in the Renault company.<sup>22</sup> More generally, it can also be said that a linked network of the industry at large will ensure that the technology receiving suppliers can in turn transfer this knowledge to their suppliers, setting off a multiplying effect (Lorentzon et al 2003, 5). The introduction of the Twingo model will further strengthen linkages by increasing the importance of the automotive and transport-logistic clusters in Slovenia. Since the model will be exclusively produced in Novo mesto for the whole European region, this will attract additional suppliers to Slovenia and “strengthen Slovenia’s position as a European producer of cars and car parts” (ACS 2004, 11). Seeing as Revoz goes by the just-in-time production principle, the frequent disturbances in railway transportation in Europe makes Revoz to fully rely on road transports (interview 10-05-07). The business opportunities for the transport-logistics cluster have thus opened up, and plans of a distribution center close to the Revoz plant are underway (ACS 2004, 11).

It is also important to include the creation of *indirect jobs* into the group of positive spillover effects coming from Revoz. In particular the recent expansion is crucial, as first estimates showed an increase in 500 indirect jobs (ACS 2004, 11). This number however only includes direct local suppliers; including creation of jobs further up in the supply chain as well as the increased demand for public goods from workers at Revoz and its suppliers will add to that number substantially.

Revoz considers *training of workers* and improvement of the overall qualifications of the workforce to be one of the company’s main focuses. Training of workers at the Revoz plant averages 65 hours per worker and year and takes place continuously, from once a month to

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<sup>22</sup> <https://suppliers.renault.com/wps/portal> (10-07-07)

once a year. However, this number was significantly higher during the years before the introduction of the Twingo. A share of the capital invested by the Slovenian government in the project was specifically aimed at training of workers (interview 10-05-07). At Revoz, a so called “integration seminar” is held for each new worker starting at the plant, lasting two days before the worker begins. Additionally to that, continuous training is carried out as new programs and production systems are introduced (interview 10-05-07). Key types of training carried out at the plant are practical, covering technical and production systems, followed by language education, staff expertise, computer science, quality, and management (www.revoz.si 10-07-07). Training of engineers also takes place abroad and is coordinated by Renault. With a wide-ranging cooperation between the Renault plants, employees can be sent to various locations, not only to the central in France (interview 10-05-07). As employees eventually transfer to other firms, they carry along the acquired knowledge. If the technology systems do not exist in the new company, spillovers are bound to take place.

Revoz also carries out much cooperation with local universities and other research centers, in particular the higher education center and the School of Business and Management in Novo mesto.<sup>23</sup> Apart from providing opportunities to intern at the plant, Revoz also offers part time work to students. Engineering departments are also assisted with car parts and other types of expertise assistance for their practical education (interview 10-07-07).

In the south-east region of Slovenia, surrounding Novo mesto, there are 1 500 registered companies of which 29 are classified as large (Slovenia Times 06-21-07). This easily puts high strains on the local *infrastructure*, especially the transport links. As production in Revoz expands, it becomes more crucial to speed up the planned construction of highway links connecting northern and southern Slovenia, something that the government has initiated and plans to have completed by 2013 (Slovenia Times 06-21-07). This will enable workers to become more mobile and more importantly facilitate the transportation of parts to Revoz and of vehicles from the plant to distributors.

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<sup>23</sup> [http://web.socrates.cz/erasmus/partner%20search/SI1\\_Novo%20mesto.doc](http://web.socrates.cz/erasmus/partner%20search/SI1_Novo%20mesto.doc) (10-07-07)

## 6. Concluding remarks

The purpose of this thesis was to investigate inward FDI to Slovenia and which effects these inflows have on the host country. Furthermore, the intention was to analyze how the Slovenian government can use these spillovers in an optimal way so that the whole economy benefits. To answer the questions, the theories on FDI and spillover effects were presented, where it was shown that an MNC needed to possess ownership and internalization advantages at the same time as location advantages needed to be in place in the investment receiving country in order to motivate the investor. The host country determinants of Slovenia, i.e. the country's location advantages are its EU-membership as well as the recent introduction of the Euro as the national currency. These factors are bound to facilitate the intra-regional investment inflows and the direct investments coming from countries outside of the integrated area. Slovenia's knowledge of regional markets in Western, Central, and South-Eastern Europe, along with a high-skilled workforce are further motives for foreign investors

The more active public policies to attract FDI – mainly through large privatization projects – caused an upsurge in inward FDI in the years 2001 and 2002. However, FDI inflows, in particular in relation to Slovenia's GDP remained at a level significantly lower than in the other new EU member states. The type of initial privatization methods through internal buy-outs were main contributors to this development, but also Slovenia's small local market and relatively higher wages in comparison to neighboring CEE economies. This proves that the State still had work to do in offering more direct incentives to foreign firms to make the Slovenian economy more attractive. Steps in the right directions have been taken by the introduction of the FDI Cost Sharing Grant Scheme, a more liberalized tax policy, and the plans of expanding projects in Special Economic Zones.

The positive effects that can come from more active policies towards FDI were proven with the case of Renault and the introduction of a new car model to be produced in the Revoz plant in Novo mesto. The financial grant from the Slovenian government to support the project, contributing with 10 percent of the capital, shows that the State understands the overall importance of the automotive sector for the Slovenian economy. This is supported by the tendency in the CEE region, where a fast increasing number of investors in manufacturing of cars and car parts have gathered in recent years. The State has also learned to appreciate the

far-reaching linkages that a production expansion of the country's only car manufacturer would bring. The positive effects came in the form of the creation of new jobs – direct and indirect – and increased technology transfer, as local content in the production more than doubled once the new model was introduced in Novo mesto. Furthermore, the extensive training of workers in the Revoz plant can be expected to spill over to other firms in the country through employee turnover. Automotive and transport clusters are also becoming stronger, as more suppliers are attracted to the local market.

However, to create not only a temporary upsurge in FDI, incentives need to be offered which will keep the investments coming and thus bring about a continuous flow of spillovers to the local economy. One way is through improved infrastructure, for instance in transport connections and telecommunication. Actions of this sort are already underway in Slovenia. Moreover, an effective implementation of various types of Economic Processing Zones and Special Economic Zones would also be FDI promoting. Export-oriented companies – both domestic and foreign – will be encouraged to work close together and technology will be transferred between firms in an efficient way. The important role of foreign firms in the area of R&D also needs to be recognized by the Slovenian government, as the R&D expenditure levels by local firms are behind the levels of the foreign firms (Damijan et al 2003 and Vidrih 2002). Higher levels of inter-firm R&D cooperation are incentives for further innovation and a strong base for technology transfer. Therefore, more investment efforts and attention should be given to getting foreign and local firms together in for instance technology and science parks.

This thesis has provided a qualitative examination of the positive effects that FDI brings to the host economy and the measures taken by governments to enhance the spillovers. By using the case of Renault in Slovenia it has been presented that positive direct effects as well as spillover effects in fact have taken place. Nevertheless, a more wide-ranging analysis of public policies and spillovers by the use of quantitative tests would certainly substantiate these findings. Additionally to having access to large firm data bases of foreign and local firms in Slovenia, it is necessary to let the test expand over a longer time-frame, as many spillovers occur once foreign and local firms integrate, a process which can take time. As already mentioned, large privatization projects and changes in the public policies towards FDI are still taking place in Slovenia. Therefore, qualitative analysis of FDI patterns in Slovenia will be valuable contributions in the future to the empirical research on FDI.



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Eurostat, European Commission  
SI-Stat Data Portal, Statistical Office of the Republic of Slovenia

### **Interview**

Communications department, management, Revoz (10-05-07)

# Appendix

## Appendix I

### Country profile Slovenia



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<b>Surface area</b>	20 273 km <sup>2</sup>
<b>Population</b>	2 million
<b>Population density</b>	99 persons per km <sup>2</sup>
<b>Official language</b>	Slovenian
<b>Minority languages</b>	German, Hungarian, Italian, Serbian/Croatian
<b>Independence from SFR Yugoslavia</b>	June 1991
<b>Type of government</b>	Parliamentary democratic republic
<b>Prime minister</b>	Janez Jansa
<b>EU membership/EMU membership</b>	May 2004/January 2007
<b>GDP</b>	EUR 29 741 million (2006)
<b>GDP per capita</b>	EUR 14 727 (2006)

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Source: BBC World, Country Profile (10.4.2007) and Eurostat

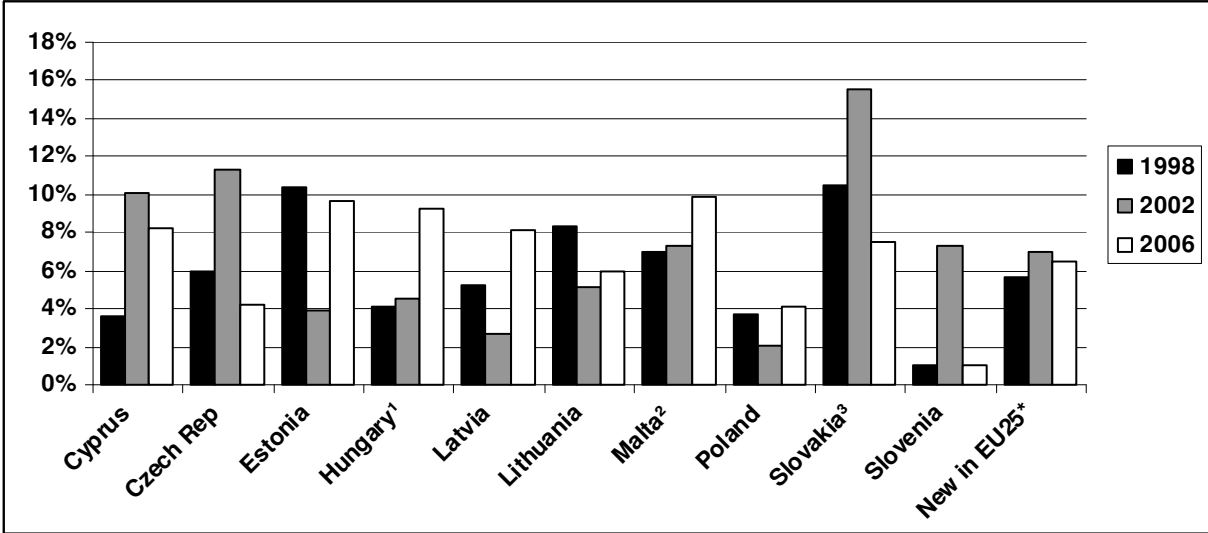
## Appendix II

### The TRIMs Agreement<sup>24</sup>

The Agreement on Trade Related Aspects of Investment Measures entered into force in 1995 and was one of the outcomes of the Uruguay Round of trade negotiations. It describes investment measures which are prohibited for its members, as they are inconsistent with the principles of the GATT (General Agreement on Tariffs and Trade) regarding national treatment and prohibition of quantitative restrictions. The main measures are local content requirements, trade-balancing requirements, foreign exchange balancing requirements, and restrictions on exports. The Agreement covers exclusively trade in goods. Temporary deviations from the Agreement in the case of balance-of-payment problems as well as extended transition periods were given to developing and least developed countries. A Committee on TRIMs was also established in order to observe the implementation of the Agreement requirements.

## Appendix III

### FDI/GDP ratio in new EU25 members, 1998-2006, percent



<sup>1</sup>1999, 2002, 2006; <sup>2</sup>1998, 2001, 2005; <sup>3</sup>2000, 2002, 2006; \*Not all countries are included due to data inaccuracy

<sup>24</sup> The information on the TRIMs Agreement is collected from WTO, [http://www.wto.org/english/docs\\_e/legal\\_e/ursum\\_e.htm#eAgreement](http://www.wto.org/english/docs_e/legal_e/ursum_e.htm#eAgreement) (10-05-07) and UNCTAD 2001, p 167.

## Appendix IV

### Inward FDI in Slovenia by activity, share of total FDI stock, 1994-2006, percent

	1994	2002	2006
<b>MANUFACTURE</b>	<b>42.5</b>	<b>44.0</b>	<b>37.1</b>
Chemicals & chemical products	6.1	13.7	13.4
Rubber & plastic products	1.1	5.1	4.8
Motor vehicles, trailers etc.	10.7	1.3	4.0
Pulp, paper & paper products	9.1	6.2	3.8
Machinery & equipment nec.	6.2	4.0	2.9
Other non-metal mineral prods	2.0	3.2	2.4
Fabricated metal, not machines	0.3	1.1	1.4
Radio, TV & equipment	1.1	1.2	0.9
Wood & wood, cork, etc. goods	0.0	0.2	0.7
Electrical machinery etc. nec.	1.7	1.3	0.6
Medical & precision instruments	0.6	0.9	0.6
Textiles	0.6	1.0	0.5
Leather tanning; mrf luggage, etc.	0.0	0.9	0.4
Basic metals	0.5	1.5	0.3
Food products & beverages	1.2	1.9	0.2
Publishing, printing & record media	0.5	0.3	0.2
Other transport equipment	0.0	0.0	0.1
Furniture; manufacturing nec.	0.3	0.1	0.0
Wearing apparel; dressing fur	0.4	0.0	0.0
<b>SERVICES</b>	<b>54.7</b>	<b>54.3</b>	<b>62.5</b>
Financial intermediation, not insur.	6.4	17.9	19.3
Other business activities	6.9	13.0	11.3
Wholesale, commission, not motors	6.8	8.2	8.3
Sale, repair etc. motors; fuel	5.2	3.9	4.5
Real estate activities	0.1	1.4	3.8
Retail trade, not motors; repairs	2.9	2.1	3.7
Electricity, gas, steam & hot water	22.4	0.6	3.7
Post and telecommunications	0.1	3.2	3.2
Insurance, pension not comp. soc. sec.	0.8	0.7	1.4
Land transport; pipelines transport	0.6	0.2	0.6
Computer and related activities	0.2	0.7	0.6
Recreational, cultural & sporting	0.0	0.5	0.6
Support transport; travel agencies	0.7	0.8	0.5
Hotels and restaurants	0.6	0.4	0.3
Collection, purify etc. of water	0.0	0.4	0.2
Water transport	0.0	0.0	0.1
Construction	0.1	0.1	0.1
Air transport	0.0	0.0	0.1
Other service activities	0.1	0.0	0.1
Refuse disposal, sanitation etc.	0.2	0.1	0.0
Activities aux. to financial interm.	0.2	0.0	0.0
Renting equipment without operator	0.3	0.0	0.0
Research and development	0.0	0.0	0.0
Health and social work	0.0	0.1	0.0
Education	0.0	0.0	0.0

<b>AGRICULTURE, MINING, AND QUARRYING</b>	<b>0.0</b>	<b>0.0</b>	<b>0.3</b>
Agriculture, hunting and services	0.0	0.0	0.1
Other mining and quarrying			0.1
Other*	2.8	1.7	0.1
<b>TOTAL</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

\*Activities having less than three companies with foreign direct investment in equity

Source: Bank of Slovenia (2004) and <http://www.bsi.si/en/financial-data.asp?MapaId=330>, author's calculations