

**LAPPEENRANTA UNIVERSITY OF TECHNOLOGY**

Department of Industrial Engineering and Management

**MASTER'S THESIS**

**EXTERNAL LOCATION FACTORS OF FOREIGN DIRECT  
INVESTMENT IN RUSSIA  
- Finnish Perspective**

The subject of this thesis has been approved by the council of the Department of Industrial Engineering and Management in its meeting on December 15<sup>th</sup> 2004.

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## ABSTRACT

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The objective of this research is to study, which are the regional attributes that Finnish companies take into consideration when they are selecting a suitable location for a direct investment inside Russia. Some company specific factors are included in the study as well. The internal factors are used as background variables that explain differences in the weightings of the location factors. Finally the Russian regions are assessed in the light of the results.

The first part of this thesis concentrates on the theoretical background of the foreign direct investment. Previous research is reviewed in order to map the factors that have been found to influence the FDI location decision inside a country. The latter part of the study is based on an empirical data set collected with the help of a mail survey. The collected data is analyzed in order to find out which factors are considered in the location decision-making in Finnish companies.

Based on the research results it seems obvious that the market potential of a potential location in Russia is the most significant factor to Finnish companies. Other significant factors include the level of infrastructure and cost benefits. No major differences in the weightings of the factors between different types of companies occurred. Moscow City and St. Petersburg are the most suitable regions for Finnish companies based on their criteria.

## TIIVISTELMÄ

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**Keywords:** Foreign direct investment, external location factors, sub-national level, Russia

Tämän diplomityön tavoitteena on selvittää, mitä alueellisia tekijöitä suomalaiset yritykset ottavat huomioon valitessaan sopivaa sijaintia suoralle investoinnille Venäjän sisällä. Muutamia yrityksen sisäisiä tekijöitä käytetään taustamuuttujina selittämään sijaintitekijöiden painotuksissa havaittavia eroja erilaisten yritysten välillä. Venäjän alueita vertaillaan lopuksi painotusten valossa.

Työn ensimmäisessä osassa keskitytään suorien ulkomaisten investointien teoreettiseen taustaan. Aiempia tutkimuksia käydään läpi, jotta tekijät, joilla on havaittu olevan vaikutusta investointien sijoittumiseen maan sisällä, saadaan kartoitettua. Työn jälkimmäinen osa perustuu yrityskyselyn avulla kerättyyn empiiriseen aineistoon. Aineiston avulla selvitetään mitä tekijöitä suomalaisyritykset huomioivat sijaintipäätöstä tehdessään.

Tulosten valossa on ilmeistä, että alueen markkinapotentiaali on suomalaisyrityksissä tärkein huomioitava tekijä investoinnin sijainnista päätettäessä. Myös infrastruktuuri ja kustannushyödyt vaikuttavat päätökseen. Erityyppisten yritysten painotukset ovat hyvin samanlaisia. Moskova ja Pietari vastaavat Venäjän alueista parhaiten suomalaisyritysten investoinnin sijainnille asettamia kriteerejä.

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At this point of my life I wish to especially thank my parents, Outi Mettälä and Heikki Laakkonen. You have always told me to believe in myself and encouraged me to fully exploit my potential. You have taught me to always aim higher. I am also ever so grateful to all my magnificent friends here in Lappeenranta. You have made my time here unforgettable. When I first came to Lappeenranta I was not sure if I was going to stay. It was the people who made me stay. I will never forget the great times we have had together. Last but not least I want to thank Johannes for supporting me during my studies. You never fail to make me laugh and with you all my problems seem to disappear.

I am now anxiously waiting to meet new challenges. In the words of John F. Kennedy: Change is the law of life. And those who look only to the past or present are certain to miss the future.

Venla Laakkonen

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## **ABBREVIATIONS**

FD	federal district
FDI	foreign direct investment
GDP	gross domestic product
GOSKOMSTAT	Russian Federation State Statistics Committee
GRP	gross regional product
RUB	Russian ruble
UNCTAD	United Nations Conference on Trade and Development
USD	United States dollar
WIIW	The Vienna Institute for International Economic Studies

# 1 INTRODUCTION

This master's thesis concentrates on studying the external factors that influence the selection of a location for a foreign direct investment (FDI) inside a country. More specifically this study focuses on Finnish companies that are operating in Russia. The thesis has been made at the Lappeenranta University of Technology at the Department of Industrial Engineering and Management at the Faculty of International Operations and Marketing.

## 1.1 Overview

Foreign direct investments play an increasingly important role in the world economy and globalization. More and more companies are extending the sphere of their operations and thus becoming trans-national corporations. Growing cross-border capital flows set new challenges for researchers as well.

The topic of FDI has attracted numerous researchers for several decades, and it has indeed been studied from various points of view. The emphasis has however recently been on the firm-specific determinants of international economic activity. This standpoint is now being complemented by a renewed interest in the spatial aspects of FDI. (Dunning 1998) Spatial aspects also form the core of this thesis.

It has been argued in several contexts (e.g. Mariotti & Piscitello 1995, Zhao & Zhu 2000) that investigation of location preferences of foreign investors within the border of a given host country is lacking. So far most studies have focused on the country choice of FDI. However the regional aspect of FDI is rather important especially if the host country is large and the basic attributes of business environment vary between its different regions.

The research concerning the FDI location criteria has largely been based on the assumption that FDI is generally associated with manufacturing companies.

However as the importance of the service sector has been growing in the global FDI scene, the research perspective should be broadened to include service sector as well.

Russian Federation is an especially interesting country from the Finnish point of view due to its geographical proximity. Russia has undergone dramatic changes during the last few decades, and these changes have created new business opportunities for companies around the world. Russia's vast markets and resources have attracted foreign companies, and foreign capital has slowly begun to flow into the country.

The need for regional aspect in the case of Russian FDI inflows is obvious, since the country is so large and circumstances so varied. Foreign companies investing in Russia face another intricate choice after they have chosen the country: they have to choose the most suitable location for their new establishment among 89 different regions.

This study combines the spatial and sub-national perspectives and applies them to the Russian case taking both manufacturing and service sectors into account. The organization-specific aspects are not completely excluded from this study: some of them are included as background variables that influence the weighting of external factors.

## **1.2 Objectives**

When a foreign investor chooses the location for an investment inside a foreign country, there are several spatial (external to the company) aspects and factors that should be taken into consideration. These aspects have been studied in the cases of some countries before, but factors affecting FDI distribution in Russia remain unexplored.

The main research question of this study can be phrased as follows:

*What are the external factors that a Finnish investor takes into consideration while choosing a location for an investment in Russia, and what is the relative importance of each of these factors?*

The sub-questions of the main research question presented above are:

- Do companies' characteristics affect the weightings of the factors?
- Which Russian regions should the Finnish investors choose based on their criteria?
- Have Finnish investors chosen the regions they should have chosen?

The first sub-question of the research allows for the inclusion of several company-specific location factors in the study.

### **1.3 Limitations of the Study**

This study focuses on the external factors of an FDI location decision. In this context external factors refer to the attributes of different locations. Company-specific attributes are included in the study only as background variables. Due to the nature of this study only those factors that can be justifiably quantified are included in the study. Internal factors such as business relations and competence are excluded from the study.

This study aims to answer the research questions set in the previous chapter by means of a company survey. The survey is directed solely at Finnish companies. The study takes into consideration all Russian regions, with the exception of some

sub-regions<sup>1</sup> on which adequate statistical data is not available. These sub-regions will be treated as parts of larger administrative entities.

All lines of business, that is manufacturing, retail, service, as well as construction sectors, are included in the study. The inclusion of service sector is considered important, as its role in the developed economies has become very significant. Both companies with FDI in Russia as well as companies using other modes of operation in Russia were asked to answer the survey. Companies with no FDI in Russia are not studied in depth however they are used for comparison purposes.

#### **1.4 Structure of the Thesis**

The structure of this study is presented in Figure 1. The two basic dimensions of this study, location factors of foreign direct investment and the Russian economy, are brought together with the help of a survey.

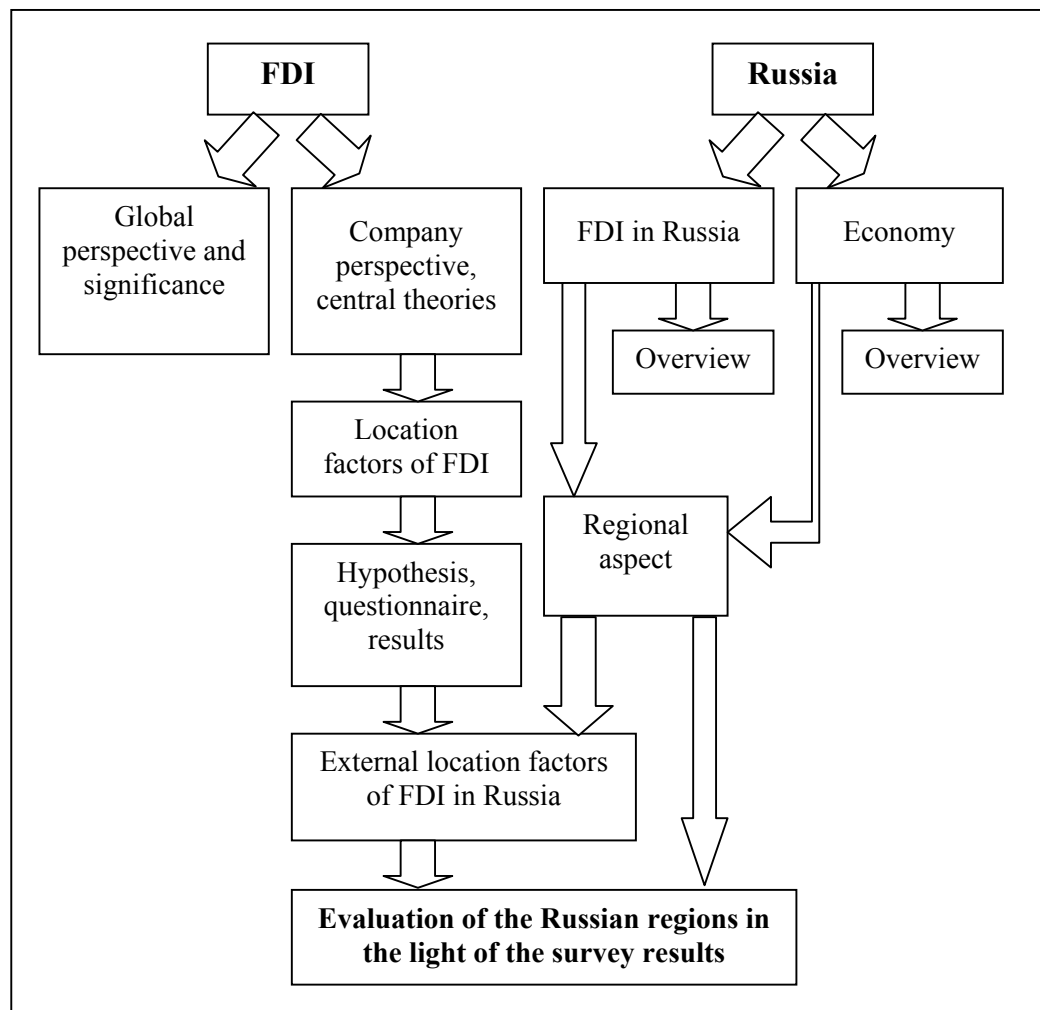
Chapter 2 of the thesis aims to describe and explain the FDI phenomenon in general. This chapter offers the reader essential background information that is needed to piece together the overall FDI scene and it also provides basis for the selection of the so-called background variables (company characteristics affecting the location decision criteria). Chapter 2.1 focuses on the global view and the significance of FDI in the global economy, while Chapter 2.2 approaches the subject from company's point of view acknowledging the business process nature of the direct investment. Chapter 2.3 concentrates on the central theories of FDI. Chapter 2.3 also helps the reader to grasp the position of the location decision as a part of the FDI process.

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<sup>1</sup> Nenets, Komi-Permyak, Khanty-Mansii, Yamal-Nenets, Taimyr, Evenk, Ust-Orda, Aga-Buryat, and Koryak Autonomous Okrugs

Chapter 3 is the core of the theoretical part of the thesis. In chapter 3 the theories concerning the factors affecting FDI location on both national and sub-national level are reviewed in detail. Chapter 3 also forms the basis for the questionnaire formulation, as several assumptions concerning the location criteria are presented in this specific chapter.

Chapters 4 and 5 review the Russian economy. Chapter 4 is a brief and generic description of the Russian economy, and it also aims to justify the need for the regional perspective in studying FDI in the case of Russia. In Chapter 5 the Russian FDI inflows are examined in detail.



**Figure 1. Structure of the study**

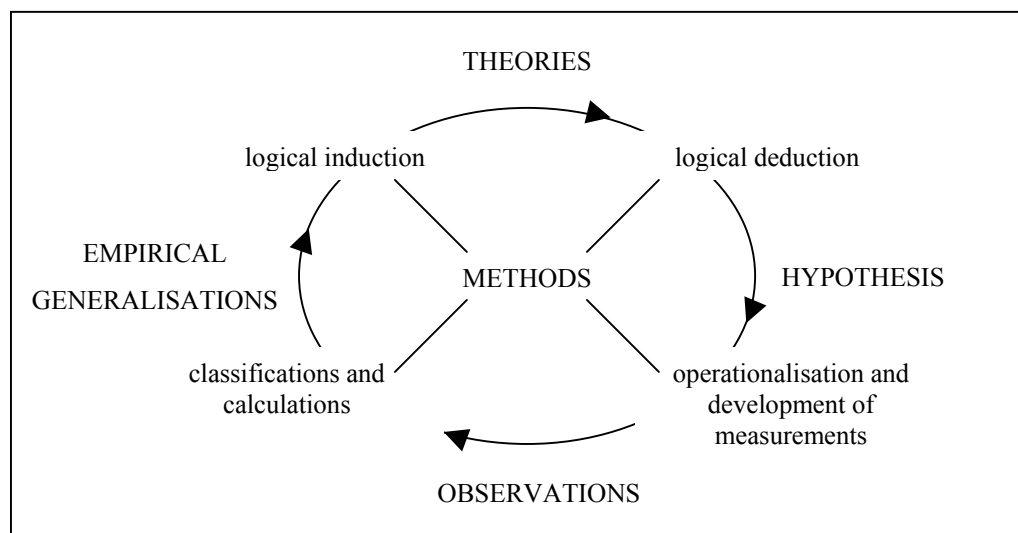
The implementation process of the company survey as well as the description of the analysis methods applied is presented in Chapter 6. The actual results of the study are presented in Chapter 7. In Chapter 7 the factors that most heavily influence the location decision are presented. Based on the factor weightings and existing statistical data on the Russian regions the attractiveness of the Russian regions from the Finnish company perspective can be evaluated.

The key results of the thesis are summarized in Chapter 8.

## 1.5 Research Methods

This thesis is based on quantitative analysis of survey results and existing statistical data. Both of these methods have been used in previous literature on FDI location, but seldom have they been used together.

Wallace (1969, p. ix) has created a cyclic model of the research process (Figure 2).



**Figure 2. Wallace's model (Wallace 1969, p. ix)**

In Wallace's model logical deduction is used to derive hypotheses from a chosen theory. Measurable and observable questions are then used to obtain data for

testing the hypotheses. The observations are analyzed, and the hypotheses are confirmed or falsified. As a result either the old theory is confirmed or a new theory is derived.

The structure of this study follows Wallace's model. A number of assumptions concerning the FDI location decision-making criteria are made based on the theoretical part of the thesis. These assumptions are then analyzed with the help of an empirical data set, which is collected via company survey. The data set will then be analyzed with SPSS, a statistical computer program.

On a more concrete and specific level the basic research process can be seen as a chain consisting of six steps. These steps are (1) problem formulation, (2) determination of the research design, (3) design of data collection method and forms, (4) design of the sample and data collection, (5) analyzing and interpreting the data and (6) preparation of the research report. (Churchill 1995, p. 81) These tasks are also carried out in this study's framework. Steps 2, 3, 4, and 5 form the basis for the implementation of the survey.

## **2 FOREIGN DIRECT INVESTMENT**

This chapter focuses on the description of the FDI phenomenon in general. FDI is firstly reviewed as a part of the global economy. Secondly the phenomenon is approached from the business point of view, after which central FDI theories are presented. These perspectives are included in this study to help the reader understand the significance and nature of FDI. FDI theories help to understand the role of the location decision in the FDI process.

### **2.1 FDI in the Global Economy**

In the beginning of the 21<sup>st</sup> century we are witnessing the globalization of markets and production. This shift sets new challenges to businesses all over the world. (e.g. Root 1994, Hill 1997) Companies are increasingly dispersing parts of their operations to various locations around the world to take advantage of national differences in the cost and quality of production factors. Factors that have resulted in the increasing importance of international markets over the past 20 years include the lowering of barriers to trade and investment, more international capital markets, and excess capacity in a wide range of industries in many countries. (Albaum & al. 2002, p. 1)

A company that operates internationally has to engage in modes of business that differ from those it is accustomed to domestically. There are several ways for companies to launch their foreign operations. Foreign direct investment is one way to conduct international business operations, while other methods include such modes of business as exporting and importing.

#### **2.1.1 Definition of FDI**

Direct investment is a term used to describe such financial flows that are accompanied by managerial involvement and effective control. International

Monetary Fund (1993, p. 86) defines foreign direct investment as follows: “*direct investment is the category of international investment that reflects the objective of a resident entity in one economy obtaining a lasting interest in an enterprise resident in another economy*”.

As the above-mentioned definition is open to various interpretations, the Organisation for Economic Co-operation and Development (1996, p. 6) has recommended that a direct investment enterprise should be defined as an enterprise in which a foreign investor owns 10 per cent or more of the ordinary shares or voting power.

Krugman and Obstfeld (2000, p. 169) include the concept of *subsidiary* in the FDI definition. FDI is an international capital flow in which a firm in one country creates or expands a subsidiary in another. In their definition Krugman and Obstfeld also emphasize the significance of *control* in FDI.

It has to be kept in mind, that FDI is not the only possible mode of foreign investment. It is important to recognize the distinction between FDI and foreign portfolio investment. Foreign portfolio investment refers to an investment made by individuals, firms, or public bodies in foreign financial instruments. Thus the portfolio investment does not lead to a significant equity stake in a foreign business entity. (Hill 1999, p. 176)

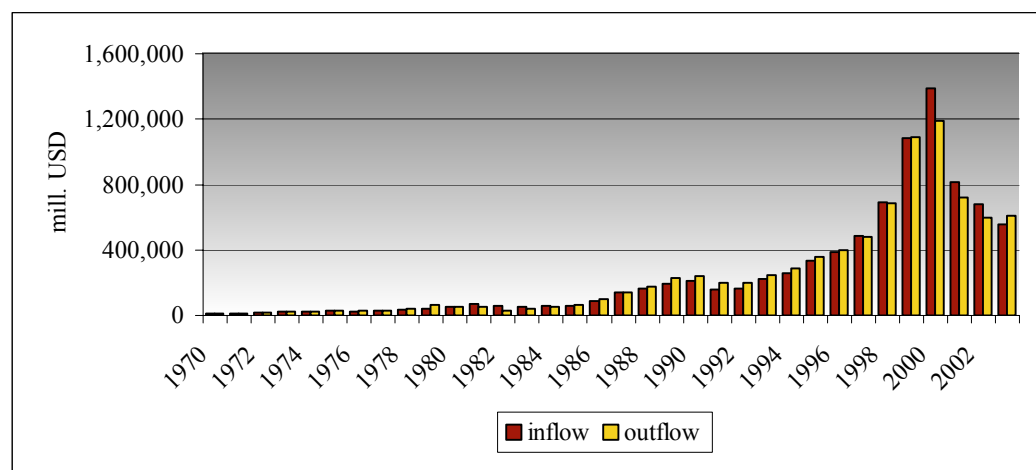
There are two separate attributes that are used to describe the FDI movements in the world. The concept *flow of FDI* refers to the amount of FDI that has been undertaken over a given time period, whereas the concept *stock of FDI* refers to the accumulated value of foreign direct investments at a given time. (Hill 1999, p. 177)

### 2.1.2 FDI Flows in the World

The past 20 years have witnessed a marked increase in foreign direct investment activities in the world economy. FDI flows have been growing more rapidly than world trade and world output. There are several reasons behind this development.

First of all FDI can be seen by the business executives as a way of circumventing future trade barriers. The recent increase in FDI flows has also been driven by the political and economic changes that have occurred in many of the world's developing nations. FDI has been encouraged by the shift towards democratic political institutions and free market economics. Much of Asia, Eastern Europe and Latin America have for example become increasingly attractive in the eyes of foreign investors due to their economic growth, economic deregulation, privatization programs that are open to foreign investors and the removal of many restrictions on FDI. (Hill 1997, pp. 177-178)

The world FDI flows in recent decades are depicted in Figure 3.



**Figure 3. World FDI flows 1970-2003 (UNCTAD 2004a)**

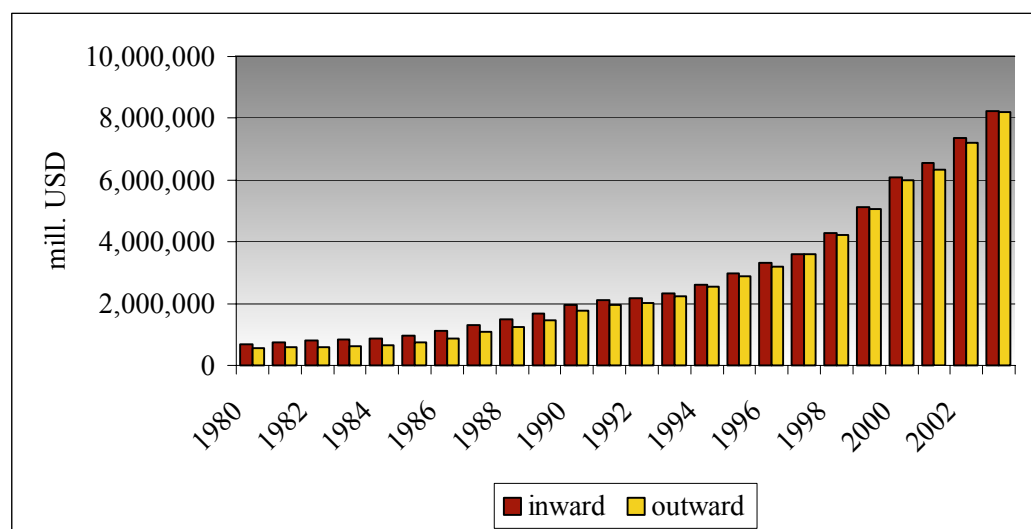
In the beginning of the 21<sup>st</sup> century global FDI flows have however started to decrease. In 2000 the total amount of FDI inflows in the world was roughly 1,400 billion USD, but in 2001 this figure was down by almost 40%. In 2002 FDI

inflows fell by another 20% to roughly 650 million USD. (UNCTAD 2003, p. 3) Reasons behind the downtrend in FDI activities include the continued slowdown of the global economy, concerns about international security and the preference on the part of many companies to consolidate acquisitions instead of making new ones. (Organisation for Economic Co-Operation and Development 2004)

According to UNCTAD (2003, pp. 3-4) the FDI downturn can be considered somewhat uneven. For example Asia has been able to avoid the FDI slump mainly thanks to record high flows to China. Manufacturing and service sector have been hit harder than the primary sector.

In 2003 global FDI inflows continued to fall. However outflows increased, and as the economic climate has started to improve, a recovery might be on its way in 2004. (UNCTAD 2004b, p. 3)

Even though the FDI flows have declined in recent years, world FDI stock has naturally kept on growing. Only the growth pace has been affected. The stock has almost quadrupled in ten years. The dynamics of the world FDI stock are depicted in Figure 4.



**Figure 4. World FDI stock 1982-2003 (UNCTAD 2004a)**

The geographical distribution of world inward FDI stock in 2003 is presented in Table 1. It is obvious that the developed countries dominate the FDI scene, as Europe's and USA's combined share of world inward FDI stock is over 60% and of outward FDI stock over 75%. Thus it seems that capital flows from one developed country to another. Developing countries have however increasingly contributed to world FDI flows.

**Table 1. Geographical distribution of world FDI stock 2003  
(UNCTAD 2004b)**

Inward FDI stock 2003			Outward FDI stock 2003		
Host country	Mill. USD	% of world total	Home country	Mill. USD	% of world total
Europe	3,538,135	42.9	Europe	4,421,992	53.9
USA	1,553,955	18.8	USA	2,069,013	25.2
Africa	167,111	2.0	Africa	39,459	0.5
Latin-America	647,678	7.9	Latin-America	183,843	2.2
Asia excl. China	960,047	11.6	Asia excl. China	597,786	7.3
China	501,471	6.1	China	37,006	0.5
CEE excl. Russia	210,752	2.6	CEE excl. Russia	14,054	0.2
Russia	52,518	0.6	Russia	51,809	0.6
Other	610,407	7.4	Other	781,900	9.5
<i>Total</i>	<i>8,245,074</i>	<i>100.0</i>	<i>Total</i>	<i>8,196,863</i>	<i>100.0</i>

A recent trend in FDI patterns is the shift towards services. The service sector's increasing share of world FDI movements is no surprise, as services have become an essential component of GDP in many countries. The non-tradable nature of services also forces service companies to produce services locally instead of exporting them. (UNCTAD 2004b, p. 97)

### **2.1.3 Political Perspective**

Governments can both encourage and restrict FDI via their choice of policies. Historically political ideology has been an important determinant of government FDI policy. Political ideology has ranged from a radical stance that is hostile towards FDI to a noninterventionist, free market stance that supports FDI.

However as communism collapsed in the beginning of the 1990s, the radical view was in retreat everywhere by the mid-1990s. (Hill 1999, p. 218)

Most nations can be considered pragmatic nationalists when it comes to FDI. These nations view FDI as having both benefits and costs<sup>2</sup>. This sort of pragmatism leads to the pursuit of policies that maximize the benefits and minimize the costs of FDI. (Hill 1999, p. 218)

## **2.2 FDI as a Mode of Internationalization**

Foreign direct investment has naturally its own implications for companies employing this specific method of internationalization. These implications are reviewed in the following.

### **2.2.1 FDI – one of several possibilities**

Even though FDI has become an increasingly popular mode of internationalization in the recent years, there are several other possibilities to go international as well.

An institutional arrangement that makes possible the entry of a company's products, technology, human skills, management or other resources into a foreign country is called an *international market entry mode*. A domestic company does not face the problem of entry mode selection, as it already operates in the market. In contrast a foreign company initially stands outside the foreign country and market, which means that it first has to find a way to enter the country and its markets. (Root 1994, p. 25)

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<sup>2</sup> See Hill 1999, p 218 for a detailed listing of benefits and costs

A basic way to categorize the entry modes is to divide them into two groups. First group contains all activities that include exporting products into one country from a production base outside that country. The second group contains activities that are based on resource transfer to the foreign country. Companies employing operation modes that belong to the latter group serve local markets with local production units. FDI is an example of such activity. (Root 1994, p. 26)

Compared to for example exporting, direct investments and joint ventures (which are in some cases considered direct investments as well) mean greater commitment, risk, control, and profit potential. (Kotler 2001, p. 374)

### **2.2.2 FDI in Practice**

Production and marketing facilities are the concrete embodiment of foreign direct investments. Manufacturing plants and other business units may range from simple assembly plants that depend entirely on imports of intermediate products to plants that undertake the full manufacturing process. (Root 1994, p. 28)

Other foreign business units that can be labeled as FDI, if they fill the other requirements, include such operations as sales promotion units, sales units, purchasing units, research and development units, warehouse units, technology transfer units, financing units, and holding units (Luostarinen & Welch 1990, pp. 166-172).

The starting up of a subsidiary may take place through acquisition or through building from scratch. The advantages of acquisition lie in its rapidity and instant readiness. The foreign company avoids the trouble of hiring personnel, building distribution channels and finding customers. However in some cases the so-called greenfield investment may be more appropriate. If for example there are no suitable companies available for purchase in the desired region, the foreign company has no choice but to build its own facilities from scratch. (Luostarinen & Welch 1990, pp. 164-166)

### **2.2.3 Advantages and Disadvantages of FDI**

Root (1994, pp. 144-146) has listed the advantages and disadvantages of investment entry. As direct investment is about transferring an entire enterprise to a target country, it enables the company to fully exploit its competitive advantages in the target market. Savings in transportation and production costs and in customs duties can make local production more profitable compared to exporting. Local production can also be used to overcome such trade barriers as import quotas. Better control over the operations also guarantees better quality than could be attained through licensing. In addition investment entry can create marketing advantages, as the company is more in touch with its clients. In the case of service sector local presence can be a precondition of doing business, since it is in services' nature that they often cannot be transferred from one place to another.

Local production can also be considered to improve the image of a foreign company, since it creates jobs. Improved image naturally boosts business as well. (Kotler 2000, p. 378)

According to Root (1994, p. 145) the disadvantages of investment entry include the increased need for capital, management and other company resources, which also increased the risks involved. Other drawbacks of investing are high start-up costs, long payback periods and the difficulty of disinvestment in the case of failure or a change in strategy.

## **2.3 FDI Theories**

As Dunning (2001) has suggested that no single theory can explain all cross-border transactions, it is useful to familiarize oneself with several theories and viewpoints that aim to clarify the factors determining global FDI flows. However, it is not convenient in this context to summarize the multitude of theories that have been offered to explain companies' FDI behavior. Instead few most salient

and comprehensive frameworks for internationalization will be presented in this chapter.

### **2.3.1 Early FDI Theories**

Earlier FDI theories did not analyze the subject of FDI from the perspective of the theory of the firm, but instead their perspective was more macroeconomic by nature. For example the capital arbitrage theory suggests that equity capital flows from countries where its profitability is low to countries where it is high. This theory implicitly suggests that capital abundant countries should export capital and capital scarce countries should import capital. The capital arbitrage theory however does not hold in practice, since many countries are both a source of and a host to FDI and the capital often flows from one capital abundant country to another. (Piggot & Cook 1993, p. 332)

The international trade theory originally did not have much to say about FDI. The theory suggested that countries would specialize in the production and export of those commodities which best fit the country's resource profile. The model is built on the assumption that factors of production are immobile across national boundaries thus excluding FDI from the model. As the model received plenty of criticism, several attempts to introduce more realism into the model have been made. For example some of the factors, which play an important role in the motivation of FDI, have been included in the orthodox theory of trade as well. (Piggot & Cook 1993, p. 332)

Independently from the developing theory of international trade, some researchers started to study the FDI from the perspective of a single firm. (Piggot & Cook 1993, p. 334)

### **2.3.2 OLI-Framework and Eclectic Paradigm**

As separate theories concentrating either on macro- or microeconomic aspects of FDI could not offer an extensive explanation for the phenomenon, it became obvious that these two theoretical strands should be brought together. (Piggot & Cook 1993, p. 334)

The earlier theories explained FDI mainly in terms of location specific advantages. The Hymerian view was the first model to bring together both the location specific advantages as well as the organization specific ones in an explanation of FDI. The Hymerian view however does not take into consideration the so-called internalization aspect. According to internalization theory a firm decides to engage in FDI because the best way to exploit the advantages of the company is to keep control and ownership of the advantage to itself. Dunning's eclectic theory is an attempt to integrate the Hymerian view with the concept of internalization. (Piggot & Cook 1993, pp. 334-338)

Dunning's eclectic paradigm (1980), which is also known as the OLI-theory, is one of the most quoted frameworks in FDI research. According to the theory foreign direct investment arises when three advantages are available. First of all the foreign company has to possess ownership specific advantages (O), meaning that it has to be able to perform considerably better than its indigenous competitors. Secondly the foreign location should offer the investing company some location specific advantages (L) that make local production more profitable than exporting. The third precondition for FDI is internalization advantage (I). Internalization advantages explain why companies choose to exploit their ownership specific advantages internally instead of selling them or their rights to other organizations. In this study the focus is on the location specific advantages.

### 2.3.3 REM Model

The REM model (Liuhto 2001, p. 16) is an attempt to create a more holistic view of the FDI. It combines several theories and converts them into a process model. The model is presented in Figure 5.

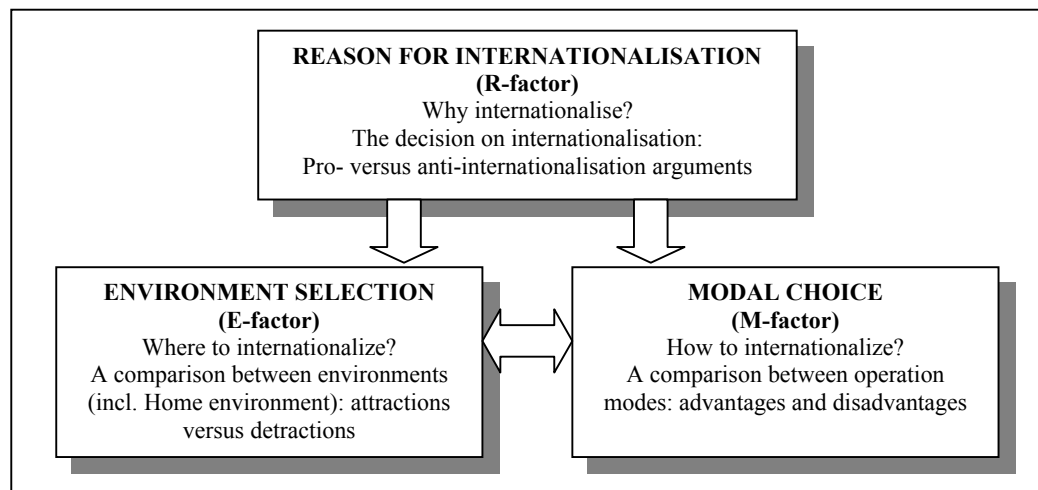


Figure 5. REM model (Liuhto 2001, p. 16)

The letter **R** stands for the reason for internationalization. Root (1994, p. 143) has divided international investors into three categories based on their primary motive. According to him investors can be classified as *extractive investors*, *sourcing investors* or *market investors*. An extractive investor establishes foreign subsidiaries in order to exploit natural resources, while a sourcing investor wishes to obtain cost benefits by operating abroad, and exports all production to the home country or to third countries. Market investors wish to penetrate the local market via investment. Dunning (1998) divides the driving forces behind a company's internationalization into four categories. Aspiration to become an international company can be caused by search for *resources*, search for new *markets*, search for *efficiency*, or by search for *strategic assets*.

Previous studies have shown that new markets have been the primary motive for foreign firms investing in CEE countries. (Uhlenbruck 1997)

**The letter E** stands for environment selection. This particular dimension is the focus of this thesis, and it will be discussed in detail in the next chapter.

**The letter M** stands for modal choice. Modal choice refers to the selection of an entry mode. The alternative entry modes were already presented in the beginning of previous chapter. Such factors as high transportation costs, lack of domestic capacity, import barriers, benefits from vertical integration, need to diversify customer and supplier bases, and competitive situation favor the choice of FDI as a mode of internationalization<sup>3</sup>.

The REM model suggests that the modal choice as well as the reason for internationalization influence the environment selection decision. Thus a company seeking new markets bases its location decision on different criteria than a company seeking resources, and companies with FDI appreciate different regional attributes than companies who resort to exporting.

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<sup>3</sup> See Daniels & al. 2001, p. 244 for a more complete listing of the factors favoring the selection of FDI

### **3 LOCATION FACTORS OF FDI**

This chapter concentrates on the core of this thesis. In the following numerous factors influencing the selection of FDI location are identified based on previous research. In the first part of the chapter the focus is national and in the second part sub-national. The second part also forms the basis for the compilation of the questionnaire employed in this study.

The selection of the investment location is an inevitable part of the FDI process. Both the eclectic model and the REM-model include the location decision in their triads.

Dunning's (1980, 1998, 2001) eclectic paradigm builds on the assumption that an MNE invests in the most advantageous location. This linkage can be considered dyadic: in the other end there is the company itself and in the other end its location decision. Tahir (2000, pp. 6-14) divides the factors affecting this decision in three categories based on Dunning's framework. These categories are firm-specific variables, internalization variables, and location-specific variables.

The emphasis of the research of multinationals has in the past few decades been on the firm-specific determinants of international economic activity. The spatial approach has however evoked more interest recently. (Dunning, 1998) The location-specific variables are the focus of this study as well. These variables are discussed in this chapter.

#### **3.1 National Level**

Each country has its own set of attributes that define the business environment in that specific country and affect the location decision of a company that is about to make an investment abroad. The location-specific variables have been discussed

in several publications, and there are many ways of categorizing and defining them.

Dunning (1993, 1995) has identified the following location-specific advantages:

- Market size and growth
- Natural and created resource endowments and markets
- Input prices, quality and productivity
- International transportation and communication costs
- Investment incentives and disincentives
- Artificial trade barriers
- Societal and infrastructure positions
- Language, ideological, cultural, business, political etc. differences
- Economies of centralization
- Economic system and policies of government

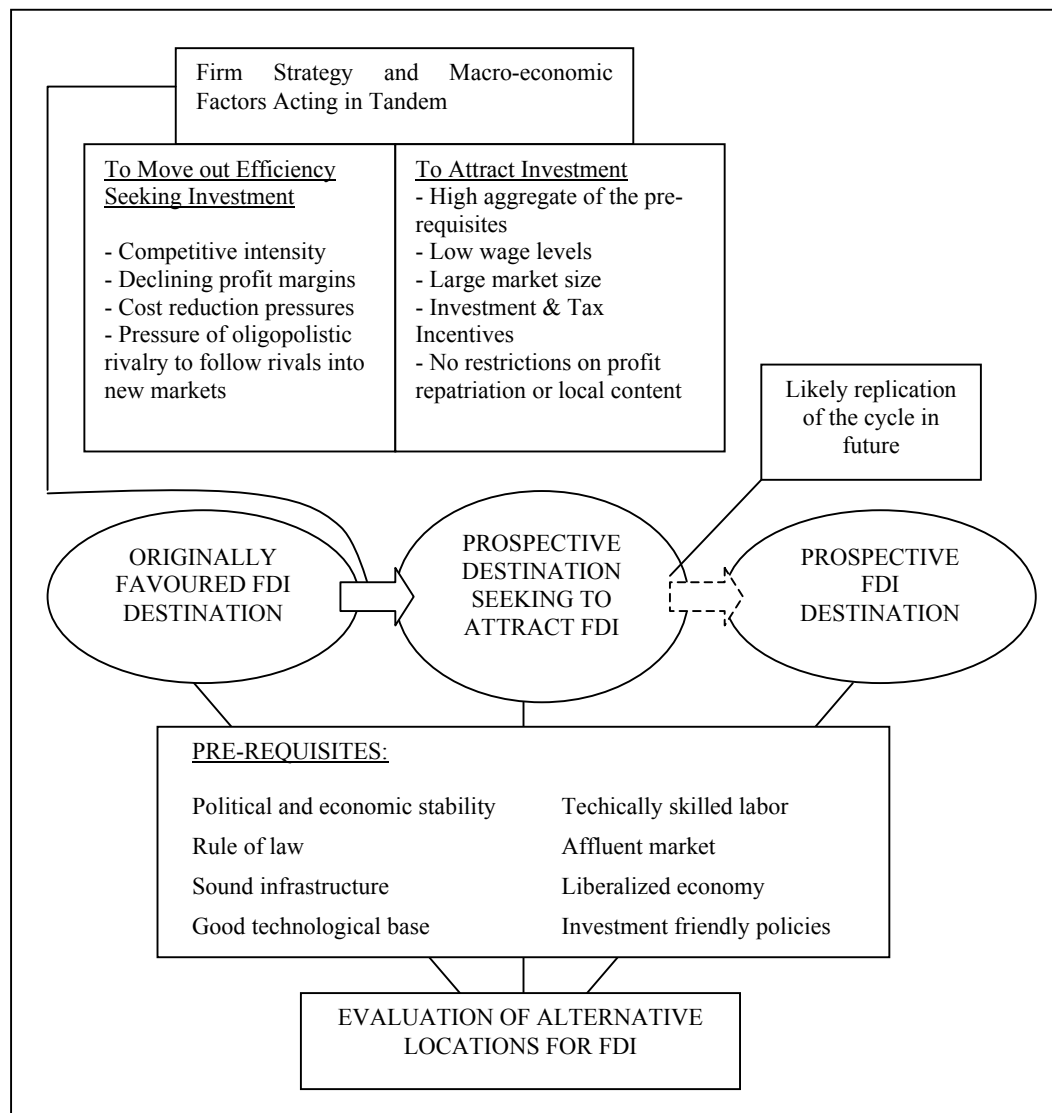
Tahir (2000, pp. 14-25) lists cultural distance, per capita gross national product, wage rate, length of income tax holidays, inflation rate, and political risk as location-specific variables. Mudambi (1995) on the other hand arranges locational factors into three basic groups: business and political risk factors, infrastructural factors, and policy factors relating to the openness of the domestic economy.

The Uppsala Internationalisation model (Johanson & Vahlne 2001) also bears some significance when the location selection is considered. In the Uppsala model the internationalization of the firm is seen as a process in which the enterprise gradually increases its international involvement. According to the Uppsala model companies start their foreign activities in countries with small psychic distance.

The Uppsala Model is somewhat inconsistent with the eclectic paradigm, as the basic assumptions of these two models are so different. Uppsala model is based on behavioral theories while the theoretical underpinnings of the OLI model assume that the decision makers have access to perfect information. While Dunning emphasizes rationality, Uppsala model places uncertainty avoidance in the center

and assumes that no optimization will occur. The eclectic paradigm can be considered static in nature, while the internationalization model pays more attention to changes in the explanatory variables as the process proceeds. (Johansson & Vahlne 2001)

In their study Sethi & al. (2003) state that the time perspective should be built in to the theoretical framework of FDIs. Factors favoring company's initial investment into a country can change over time thus prompting the company to move new investments elsewhere.



**Figure 6. Factors influencing FDI trends (Sethi & al. 2003)**

US companies have traditionally favored Western-European countries with high GDPs, low populations, and close cultural proximity in their investment decisions. This trend is however changing: US FDI flows increasingly gravitate towards regions and countries with low GDPs such as Asia. Cultural proximity is also loosing its significance as a determinant, and countries that are rich in people such as China and India are increasing their popularity as investment locations. The framework built by Sethi & al. (2003) to model the reshaping of the location factors is presented in Figure 6.

### **3.2 Sub-national Level**

A company planning to invest abroad does not only make the decision about the target country, it has to choose the region inside the country as well. Several studies (e.g. Taylor 1993, Coughlin et al. 1991) indeed support the assumption that regional distinctions within countries also influence the location of FDI. Large countries, in particular, have multifarious economic and physical landscapes. In this setting regions within a country may possess unique characteristics that provide distinctive sources of competitive advantage for MNE's FDI activities. (Chadee & al. 2003)

As Chadee & al. (2003) point out, up till now most studies concerning FDI have considered location choices between countries. Those studies that have considered location issues within countries have mainly focused on FDI distribution in developed countries (e.g. Bartik 1985, Swamidass 1990, Coughlin & al. 1992, Woodward 1992, Billington 1999, Taylor 1993). In the light of the FDI statistics presented in Chapter 2.1 this focus is not surprising. Until recently most of the world's FDI has taken place in developed countries. However as the geographic distribution of FDI is slowly changing, it becomes increasingly important to study FDI behavior in developing countries as well.

Even though much of the research made on the location choices of FDI has concentrated on the choice between countries, several studies about the factors affecting FDI distribution within one country have been made. Key findings of these studies are presented in Table 2.

**Table 2. External location factors of foreign direct investment**

<b>Factor</b>	<b>Effect*</b>	<b>Author (market)</b>
Good infrastructure	+	Bartik 1985 (US), Hill & Munday 1991 (UK), Woodward 1992 (US), Coughlin & al. 1992 (US), Friedman & al. 1992 (US), Smith & Florida 1993 (US), Head & Ries 1996 (China), Chen 1996 (China), Zhao & Zhu 2000 (China), Cheng & Kwan 2000 (China), Sun & al. 2002 (China)
High labor costs	-	Bartik 1985 (US), Coughlin & al. 1992 (US), Friedman & al. 1992 (US), Hill & Munday 1991 (UK), Cheng & Kwan 2000 (China), Sun & al. 2002 (China)
	+	Smith & Florida 1993 (US), Zhao & Zhu 2000 (China)
Large markets / market potential	+	Swamidass 1990 (US), Coughlin & al. 1991 (US), Friedman & al. 1992 (US), Woodward 1992 (US), Chen 1996 (China), Cheng & Kwan 2000 (China), Zhao & Zhu 2000 (China), Sun & al. 2002 (China)
High unemployment rate	+	Coughlin & al. 1992 (US), Friedman & al. 1992 (US), Billington 1999 (UK)
	-	Woodward 1992 (US), Taylor 1993 (UK)
High unionization	-	Bartik 1985 (US), Swamidass 1990 (US), Woodward 1992 (US)
	+	Coughlin & al. 1992 (US), Friedman & al. 1992 (US)
Agglomeration	+	Bartik 1985 (US), Coughlin & al. 1992 (US), Woodward 1992 (US), Smith & Florida 1993 (US), Head & Ries 1996 (China)
High productivity	+	Friedman & al. 1992 (US), Woodward 1992 (US), Head & Ries 1996 (China), Billington 1999 (UK), Zhao & Zhu 2000 (China)
Preferential public policies, investment incentives	+	Hill & Munday 1991 (UK), Woodward 1992 (US), Taylor 1993 (UK), Head & Ries 1996 (China), Cheng & Kwan 2000 (China)
High taxes	-	Bartik 1985 (US), Coughlin & al. 1992 (US), Friedman & al. 1992 (US), Woodward 1992 (US)
High level of education	+	Woodward 1992 (US), Smith & Florida 1993 (US), Cheng & Kwan 2000 (China)
High population density	+	Woodward 1992 (US), Billington 1999 (UK)
Land area	+	Bartik 1985 (US), Coughlin & al. 1992 (US), Woodward 1992 (US)
Openness	+	Zhao & Zhu 2000 (China), Sun & al. 2002 (China)
Large promotional expenditure	+	Coughlin & al. 1992 (US), Friedman & al. 1992 (US)

\*a plus indicates that the correlation between the variable and FDI inflow is positive, a minus that the correlation is negative

Factors affecting the FDI location decision that have been identified in previous studies are presented in the first column on the left. The middle column presents the effect of each factor on the FDI inflows. Plus indicates that the correlation between the factor and FDI inflow is positive, and minus that the correlation is negative. Authors who have found evidence on the influence of the factor in question are listed in the third column. The region that each study concerns is presented in parentheses after the author.

All studies referred to here, have approached the subject of FDI location factors with the help of secondary data. That is they all build on existing statistical data, and use statistical methods to detect significant dependencies between the amount of FDI activity and other socio-economic variables. The approach in this study is somewhat different, as this study is based on a company survey, which provides for the use of background variables. However the results of the previous studies compose an extensive base for the formulation of the survey questionnaire.

The factors presented in Table 2 are reviewed in the following. Assumptions concerning the effects of the factors in the Russian case are presented as well.

Among others Coughlin & al. (1992), Chen (1996), Zhao & Zhu (2000), Cheng & Kwan (2000), and Sun & al. (2002) all recognize good *infrastructure* as having an influence on the FDI location decision inside a country. The better the transportation connections in a region the more foreign investors it attracts. The level of infrastructure has been estimated in previous studies by such variables as roads (km) / surface area (km<sup>2</sup>) (Bartik 1985, Coughlin & al. 1992, Cheng & Kwan 2000), infrastructure spending (Hill & Munday 1991), railroads (km) / surface area (km<sup>2</sup>) (Chen 1996, Coughlin & al. 1992), and existence of interstate connections (Smith & Florida 1993). Satisfactory infrastructure can be considered a prerequisite for investments. Infrastructure is rarely a source of competitive advantage, but the lack of it can well be a disadvantage. (Porter 1990, p. 638) This being the case it can be assumed that the level of infrastructure is something that

foreign companies consider when selecting a suitable location for their activities in Russia.

High *labor costs* are mentioned as a significant factor deterring FDI in six articles (Bartik 1985, Hill & Munday 1991, Coughlin & al. 1992, Friedman & al. 1992, Cheng & Kwan 2000, Sun & al. 2002). However both Smith & Florida (1993) and Zhao & Zhu (2000) claim that high labor costs attract foreign investors, and Woodward (1992) found no significant dependency between labor costs and FDI inflow. As most of the articles concentrate solely on manufacturing companies, the most commonly used proxy for wage costs is the average wage in manufacturing sector.

The positive correlation between labor costs and FDI inflow in the case of China might be brought about by the fact that as the labor costs tend to be considerably lower in China than in the home country, foreign investors may perceive higher wages as an indicator of quality (Zhao & Zhu 2000). Nevertheless as most articles consider high wages a negative influence on FDI, it is assumed that their effect in the Russian case is also negative.

*Large markets* are considered an inducement for FDI (e.g. Swamidass 1990, Friedman & al. 1992, Chen 1996, Sun & al. 2002). In previous studies market size has been measured by income per capita (Coughlin & al. 1992; Friedman & al. 1992), GDP (Billington 1999), GDP per capita (Zhao & Zhu 2000; Sun & al. 2002), and number of manufacturing establishments (Swamidass 1990).

As Coughlin & al. (1992) point out, the significance of the regional market size depends on whether the company plans on serving regional or national markets. If a company aims at national market coverage regional market size will not necessarily bear any significance.

Interestingly Sun & al. (2002) note that in the Chinese case the provincial GDP bears no significant influence on FDI inflows before 1991 but becomes highly

significant after 1991. This finding indicates that foreign companies investing in China have become more interested in the Chinese markets recently.

It is expected that in Russia as well the local market size is a significant factor affecting the FDI location decision.

Previous results concerning the effect of *unemployment* on FDI location are somewhat conflicting. Coughlin & al. (1992), Friedman & al. (1992) and Billington (1999) have detected a positive correlation between region's unemployment rate and FDI inflows, while Woodward (1992) and Taylor (1993) suggest that the correlation is negative. Studies that claim that higher unemployment rate encourages foreign investors base this argument on high unemployment's positive effect on labor availability. On the other hand high unemployment rate can be a sign of weak economy, which justifies the argument that the correlation between unemployment rate and FDI inflow is negative. In the case of Russia high rate of unemployment is expected to encourage foreign investors, since most studies have concluded that the correlation is positive.

Effects of the *unionization rate* of labor force on FDI have been studied in the case of western countries. The results are however ambiguous. Bartik (1985), Swamidass (1990), and Woodward (1992) all claim that the lower the unionization rate the more attractive the region from foreign investor's point of view. Coughlin & al. (1992) and Friedman & al. (1992) have reached the opposite results. Friedman & al. (1992) offer an explanation for this contradiction. Unionization has a negative effect on FDI due to its tendency to raise wages. Both Coughlin & al. (1992) and Friedman & al. (1992) have in their studies eliminated the effect of wage differences, and only after this a positive correlation between unionization rate and FDI is discovered. However the positive influence of unionization has not been explained in either article.

In the articles concerning China unionization has not been included as a factor affecting FDI. Thus it is excluded from this study as well.

Several researchers (e.g. Bartik 1985, Smith & Florida 1993, Head & Ries 1996) agree, that *agglomeration* effects are a significant determinant of FDI location. In this context agglomeration refers to both manufacturing agglomeration as well as FDI agglomeration. Clustered production enables the capitalization of lower transaction costs and technological and information spillovers, as well as spatial and organizational integration between customer and supplier establishments (Smith & Florida 1993). Numbers of foreign funded equity joint ventures (Head & Ries 1996) and industrial enterprises (Swamidass 1990), manufacturing employment per square mile (Coughlin & al. 1991), and distance from certain manufacturing establishments (Smith & Florida 1993) have all been used as proxies for agglomeration. In this study the weighting of FDI agglomeration in location decision is studied. Previous FDI is expected to positively affect future FDI.

In addition to labor costs as such investors have to consider the *productivity* factor as well. Low wages do not necessarily mean that more units are produced for less money, as the productivity of workers might be lower in regions where wages are low. High productivity naturally encourages foreign investors (e.g. Friedman & al. 1992, Head & Ries 1996, Billington 1999, Zhao & Zhu 2000). Proxies for productivity include such measures as net value-added per employee (Zhao & Zhu 2000) and value-added per manufacturing hour (Woodward 1992). As previous research results are unanimous, it can be expected that high productivity is a criterion that a potential FDI location should live up to in Russia as well.

As was already mentioned in Chapter 2, governmental policies can influence world FDI flows. Governments can launch different kinds of programs to increase FDI inflows. *Preferential public policies and investment incentives* have been found to correlate positively with FDI inflows (e.g. Hill & Munday 1991, Head & Ries 1996, Cheng & Kwan 2000). However due to the complexity and difficulties in measuring this factor is excluded from this study.

Bartik (1985), Coughlin & al. (1992), Friedman & al. (1992), and Woodward (1992) have recognized high *tax rate* as a factor deterring FDI. In the case of China the effect of high taxation has not been tested. In the case of Russia tax rate is expected to have a negative influence on the location decision.

Woodward (1992), Smith & Florida (1993) and Cheng & Kwan (2000) have found a positive correlation between region's *level of education* and FDI attractiveness. The two first-mentioned articles take into consideration Japanese companies operating in the US. As Japanese companies are known for their carefully designed production systems and quality it is no surprise that they are drawn to locations with highly educated work force. Cheng & Kwan (2000) prove that the level of education works as an inducement in China as well. Thus the level of education is most likely an important consideration for foreign investors in the Russian case too. The level of education has been estimated in previous studies by median years of school completed (Woodward 1992), percentage of population with high school degree (Smith & Florida 1993), and percentage of over 6-year-old population with education of a certain degree (Cheng & Kwan 2000).

Two studies (Woodward 1992, Billington 1999) detect a positive correlation between *high population density* and FDI inflow. Population density can be considered a proxy for urbanization. High urbanization makes a region more attractive in the eyes of foreign investors as more urbanized areas tend to provide adequate utilities and better infrastructure. (Woodward 1992) High population density is included in this study as well. Companies are expected to consider the level of urbanization of a potential FDI location, and higher urbanization is expected to increase the location's attractiveness.

Bartik (1985) was the first to suggest that large *land area* would attract foreign investors, as it guarantees several suitable plant locations. Studies made by Coughlin & al. (1992) and Woodward (1992) support this assumption. However some studies (e.g. Friedman & al. 1992) have contradicted with it. As no

congruent results exist concerning this topic, land area is not included in this study.

The so-called *openness of the economy* correlates positively with FDI inflow – at least in the Chinese case. Openness can be measured by proportioning region's foreign trade with its GDP. (Zhao & Zhu 2000, Sun & al. 2003) Companies investing in Russia are also expected to value region's openness.

It is typical that governments somehow market their country or region to foreign investors. Coughlin & al. (1992) and Friedman & al. (1992) both found evidence that these efforts have indeed paid off and increased FDI inflows. Thus large *promotional expenditure* is a factor influencing the FDI location decision. However this aspect is excluded from this study, as it is not likely that the promotion is considered a location criterion per se. The promotion measures affect the location decision at a subliminal level, but they are not an intrinsic value.

Other factors that have been identified as affecting FDI location include region's *technological level* (Chen 1996, Zhao & Zhu 2000), *presence of ethnic minorities* (Woodward 1992, Smith & Florida 1993), *poverty rate* (Woodward 1992), *output growth* (Hill & Munday 1991), *population* (Smith & Florida 1993), *risk* (Sun & al. 2002), and *labor quality* (Sun & al. 2002). In the Russian case high R&D spending, large population, and low risk rating are expected to attract foreign investors.

The assumptions made above are summarized in Table 3.

**Table 3. Factors assumed to influence the location decision**

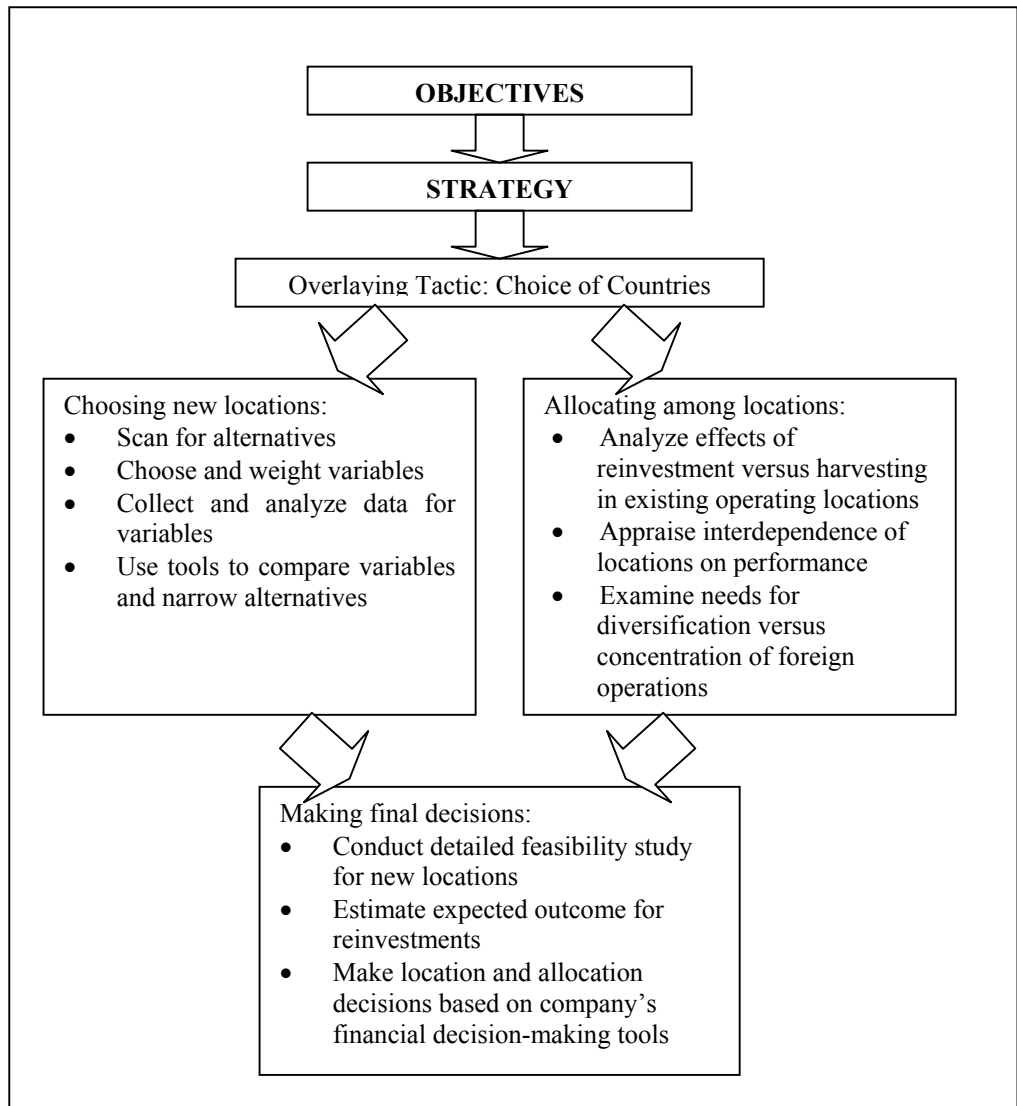
<b>The Factor</b>	<b>Expected sign of correlation between the variable and FDI attractiveness of a region</b>
Level of infrastructure	+
Labour costs	-
Markets	+
Unemployment	+
Agglomeration	+
Productivity	+
Tax rate	-
Level of education	+
High population density	+
Openness of the economy	+
R&D spending	+
Population	+
Risks	-

### **3.3 Location decision process**

The process through which the location for FDI is selected in a company is presented in Figure 7.

Underlying the actual decision process are the company's objectives and strategy. Daniels & al. (2003, p. 382) divide the phase preceding the final decision into two parallel steps. On the other hand the company needs to find new locations, and on the other hand it has to allocate and organize its activities among the different locations.

This thesis concentrates on finding new locations. The structure of the thesis reflects the phases that Daniels & al. (2003, p. 382) include in the new location selection process. The Russian regions are considered the location alternatives, and respondent companies are asked to weight the pre-selected variables. Data for these variables is collected and analyzed and the alternative locations are then evaluated.



**Figure 7. Flowchart for choosing where to operate**

**(Daniels & al. 2003, p. 382)**

## **4 THE RUSSIAN ECONOMY**

This chapter offers a brief overview of the Russian economy. The aim of the overview is to highlight the novelty and opportunities offered by the Russian economy as well as to justify the need for the regional perspective in the Russian case.

### **4.1 History**

Since the beginning of the early 1860s Russia has undergone three major economic transitions. Each one of them reshaped her socio-economic structures and property relations. The first Russian socio-economic transition took place in the tsarist Russia after the disastrous Crimean war. The second major transition in Russia began after another disastrous war, which led to the collapse of tsarist Russia and to the rise of the socialist reign. The third and the most recent transition started in the early 1990s. (Spulber, 2003, p. xix)

In this context it is reasoned to focus on the most recent transition of the Russian economy, since it has strongly shaped the current circumstances under which foreign companies have to operate in Russia.

The communist embodiment of the Russian Empire, the Union of Soviet Socialist Republics, came to its end in the end of the year 1991. Several reasons behind the collapse of the Soviet Union have been identified.

Centrally planned economy failed due to its own internal weaknesses. Economically speaking the inability to minimize costs and maximize efficiency became the most severe shortcoming of the system. Cost minimization and efficiency maximization were unfamiliar ideas in the soviet economy because the

bureaucratic units called industrial ministries lacked financial accountability. (Tiusanen & al. 1999, p. 5)

Since the end of the Soviet era Russia has changed enormously. The country no longer has an official ideology, censorship has been replaced by freedom of speech, dictatorship has been demolished, and the decision-making has become less geographically centralized. The Russian economy has also gone through tremendous changes along with the political system. The political and economic transformations have been reinforcing each other, as some economic changes have been spurred by the political reforms and vice versa. (Rautava & Sutela 2000, pp. 284-287)

The economic transition from centrally planned economy to market economy can be considered to comprise of four elements. These elements are the liberalization of prices, foreign trade and entrepreneurship, the stabilization of the economy, the privatization of publicly owned enterprises and the structural changes in various fields of the society. (Rautava & Sutela 2000, pp. 88-118) In the beginning of the 21st century the economic transition in Russia is in many ways over. (Rautava & Sutela 2000, p. 288)

It is obvious that Russia's natural and human resources set a strong foundation for sustainable economic success. The political and economic uncertainty of the Yeltsin era however impeded necessary investments. At the turn of the century several positive factors have appeared in the Russian economic scene. These factors include the forgiveness and restructuring of Russia's debt and favorable oil price development. (Tiusanen & Jumpponen 2001, p. 41)

## **4.2 Current Situation**

In the recent years the Russian economy has undergone positive developments. The GDP has been steadily increasing, incomes have risen, and unemployment

has decreased (Table 4). Russian economy is now more prepared to face harder times as well. Strong public economy and company level restructuring make the country's economy more stable and ready to confront hardship than it was in the 1990's. The Russian government has been able to pay off its debts and at the same time managed to collect a notable reserve fund. (Rautava 2003)

**Table 4. Basic macroeconomic indicators 1998-2002 (Goskomstat 2003)**

	1998	1999	2000	2001	2002
<b>Population (1000)</b>	146,328	145,559	144,819	144,210	144,083
<b>GDP (mill. USD)</b>	117,387	153,973	222,933	259,947	298,000
<b>Unemployment (%)</b>	13.2	13.0	10.5	9.1	8.0
<b>Average monthly income (RUB)</b>	1,013	1,663	2,288	3,075	3,964

Even though positive developments have taken place, there still are several questions that need to be solved until Russia can secure rapid, long-term economic growth. First of all the Russian economy suffers from the so-called Dutch Disease: the nation's economy is heavily dependent on the production of energy and raw materials, which leads to the underdevelopment of other sectors of the economy. In addition the Russian production infrastructure is out of date, investments are inadequate, the ownership of the Russian business sector is concentrated in very few hands, the small and medium sized business sector is underdeveloped, and the overall productivity is poor. (Rautava 2003, Komulainen & al. 2004)

Despite the above-mentioned problems it is generally believed, that the Russian economy will continue to develop and grow in the near future. Nonetheless it should be kept in mind that even though Russia is not threatened by an immediate crisis, the country still is rather vulnerable to changes in the world economy. (Rautava 2003) A paradox lies in the current dynamics of the Russian economy: the higher the oil price the faster the Russian GDP grows, but at the same time Russia is at risk of regressing to an oil country (Komulainen & al. 2004).

If the perspective is lengthened, Russian economic growth is going to face such problems as population decrease, absence of innovative activities, weaknesses of the education system, and the diminishing support of the increasingly authoritarian political system to the development of a more normal market economy. (Komulainen & al. 2004)

### 4.3 The Regional Perspective

Russia is the largest country in the world, and its geography and regional aspects offer a valuable dimension for its research. (Helanterä & Tynkkynen 2003, p. 10)  
A foreign company also has to take the regional differences into consideration.

The Russian Federation is divided into 89 federal subjects or regions. In this study terms federal subject and federal region will be used interchangeably. The 89 regions do not however possess equal status. First of all the status of one of the regions, the Chechen Republic of Ichkeriya, is in dispute. The remaining 88 subjects include 10 autonomous okrugs, 1 autonomous oblast, 20 autonomous republics, 55 oblasts and krajs and two federal cities. (Bradshaw & Hanson 2002, p. 3)

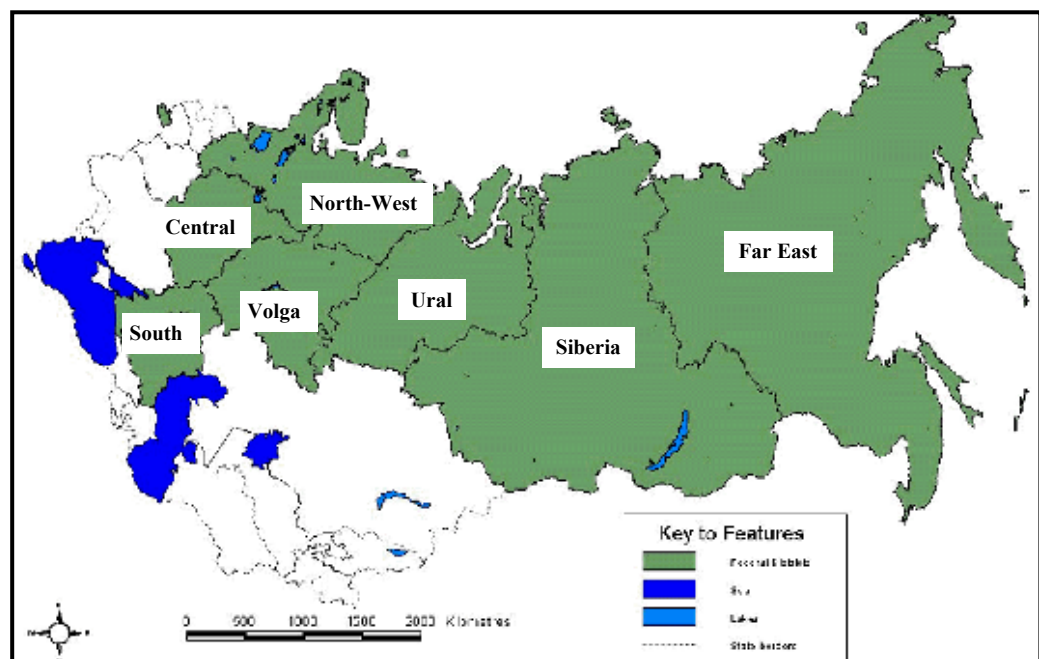
Ahjokivi (1998, p. 18) describes the different types of federal subjects as follows:

- *A republic* is an administrative unit, which is formed by a substantial ethnic group.
- *A krai* is an extensive administrative unit, which consists of two or more sub-units. Krajs are located in sparsely inhabited areas in the east and south.
- *An oblast* is a relatively homogenous and self-sufficient region. Oblasts are named after their capitals.
- *Autonomous oblasts and okrugs* are administrative units of lower status. These subjects operate as a part of a larger federal subject.

The economic situation varies greatly between the 89 federal subjects. Some of the regions possess vast natural resources while others rely on more urban sectors of the economy. (Moijanen 2002a) As Russia is such a large country, conquering the whole market of the country would demand significant investments. Thus in most cases foreign companies have to choose certain regions as targets for their business activities. (Azeem 2002)

The 89 federal subjects are divided into seven larger entities. These entities are referred to as federal districts (FDs) and they are presented in Figure 8.

It would be impossible in this context to review each of the economies of the 89 federal subjects individually. Instead the differences between different parts of the Russian Federation are demonstrated in the following via brief socio-economic review of the seven federal districts.



**Figure 8. Federal districts of the Russian Federation**

The federal districts are listed in the outermost column on the left in Table 5. Basic economic indicators for each district are presented in the same table.

**Table 5. Main Economic Indicators of the Federal Districts 2002  
(Goskomstat 2003)**

<b>Federal District</b>	<b>Population</b>	<b>GRP (mill. USD)</b>	<b>GRP / capita (USD)</b>	<b>Unemployment rate</b>	<b>Cumulative FDI inflow 1997-2002 (1000 USD)</b>
Central	37,992,000	101,554	2,673	5.4	13,076,801
Northwest	13,986,000	29,488	2,108	6.3	2,541,454
Southern	21,814,000	23,382	1,072	12.0	3,010,022
Volga	31,158,000	51,194	1,643	7.7	1,375,479
Urals	12,382,000	44,725	3,612	8.2	1,446,091
Siberia	20,064,000	32,388	1,614	10.1	886,208
Far East	6,687,000	15,269	2,283	8.6	3,029,712
<i>Russia</i>	<i>144,083,000</i>	<i>298,000</i>	<i>2,068</i>	<i>8.0</i>	<i>25,365,767</i>

The Central Federal District, which also includes the capital city of Russia, is economically speaking the center of the country. Its gross regional product is over 100 billion dollar and population almost 40 million. The Central Federal District has attracted foreign direct investments worth over 13 billion USD. Rate of unemployment (5.4 %) is the lowest among the federal districts.

The second most important “mega-region” is the Volga Federal District with its population of 30 million and 50 billion dollar gross regional product. However this district has not been nearly as successful as the Central district in attracting foreign money; its FDI inflow is roughly 1.4 billion USD.

Measured by the gross regional product Urals Federal District comes as a close third after Volga Federal District. Its gross regional production was about 45 billion dollars. However its population (12.4 million) is only half of that of Volga, and therefore the GDP/capita is rather high in the Urals Federal District.

If the population is used as a meter, the Southern Federal District is the third largest district after Volga. However the GDP remains quite low in the south, and the district’s GDP / capita (1,072 USD) is the lowest among the seven federal districts. The Southern Federal District also has the highest rate of unemployment

(12.0 %). Nevertheless the Southern Federal District has been rather successful in attracting foreign capital. Its cumulative FDI inflow is 3 billion USD.

In the Siberia Federal District the gross regional product is slightly over 32 billion US dollars, while in the Northwest Federal District it is slightly under 30 billion. However the population of Siberia Federal District is over 20 million whereas the population of Northwest Federal District is 14 million. In attracting foreign capital the Northwest has clearly been more successful than Siberia. In the Northwest the amount of foreign capital that has flown into the district since 1997 is roughly 2.5 billion USD. In Siberia the equivalent figure is roughly 0.9 billion USD.

The Far East Federal District is the smallest of the federal districts if measured by the population or gross regional product. Nonetheless it has succeeded in attracting foreign investors. Far East's FDI inflow was ca. 3 billion USD scoring second after the Central Federal District in the FDI-ranking.

## **5 FDI IN RUSSIA**

This chapter focuses on inward foreign direct investments in Russia, and describes recent FDI flows to Russia from various points of view. In the last part of this chapter Finnish companies as investors in Russia are given a closer look.

### **5.1 FDI Inflow**

The collapse of the soviet system opened the Russian market and resources to foreign companies. However compared to Russia's size and economic potential FDI inflows were meager throughout the 1990s. Political instability, economic uncertainty, corruption, and tax and regulatory burden have discouraged foreign companies from investing in Russia. The attractiveness of the Russian natural resource sector has been reduced by the absence of a functioning framework for production-sharing agreements and problematic corporate governance practices in Russia's oil majors. (Economist Intelligence Unit 2004, p. 53)

Measuring the Russian FDI inflows and FDI stock is not a simple task since there are considerable differences in the way different organizations measure FDI movements. According to Goskomstat (2004) in the end of 2003 the cumulative inward FDI stock in Russia was roughly 26.1 billion USD, while UNCTAD (2004) states that the figure is 52.5 billion USD, and the Vienna Institute for International Economic Studies (WIIW) suggests that the corresponding figure is 50 billion euros (63 bill. USD). These differences have been explained by the fact that the Goskomstat uses its own data, while UNCTAD bases its calculations on the data of the Central Bank of Russia. These two data sets differ in some ways. First of all Goskomstat figures for FDI stocks underestimate the value of FDI stocks, since the ruble component of FDI (reinvested earnings) is calculated at current exchange rates, which leads to the great undervaluing of older ruble-denominated foreign investments. On the other hand Goskomstat tends to

overestimate FDI inflows. This is because it reports gross inflows, not the net change in foreign investment liabilities. WIIW also bases its studies on the figures of the Central Bank of Russia, but its information is slightly more up-to-date than that of UNCTAD's. (Economist Intelligence Unit 2004, p. 54; Kalotay 2004; WIIW 2004)

It is common that the Bank of Russia revises the FDI data retrospectively, sometimes rather radically. The data in UNCTAD World Investment Reports is also retrospectively revised. Thus for example the data for the year 2000 might be different in 2003 and 2004 investment reports. This sort of data revision is not uncommon when it comes to the FDI statistics, but in the Russian case the degree of these revisions can be unusually large. (Korhonen 2004)

FDI stocks of the Eastern-European countries are presented in Table 6 for comparison purposes. Even though the population of Russia is over three times as big as Poland's, Russia has managed to attract only slightly more FDI than Poland.

**Table 6. FDI stock in CEE countries in 2003 (WIIW 2004)**

<b>Country</b>	<b>FDI stock (mill. EUR)</b>	<b>FDI stock / capita (EUR)</b>
Russia	50,000	348
Poland	48,000	1,257
Hungary	37,907	3,747
Czech Republic	37,626	3,685
Romania	10,118	465
Croatia	9,083	2,044
Slovakia	9,000	1,673
Ukraine	6,000	126
Estonia	5,164	3,795
Bulgaria	4,300	551
Slovenia	4,000	2,002
Lithuania	3,968	1,152
Latvia	2,665	1,149
Belarus	1,502	153

In per capita -comparison Russia's weak success is clearly visible, as only Ukraine and Belarus have attracted less foreign capital per capita. The gap

between the most successful countries (Estonia, Hungary and Czech Republic), which have attracted FDI worth over 3500 euros / capita, and Russia, less than 500 euros is striking.

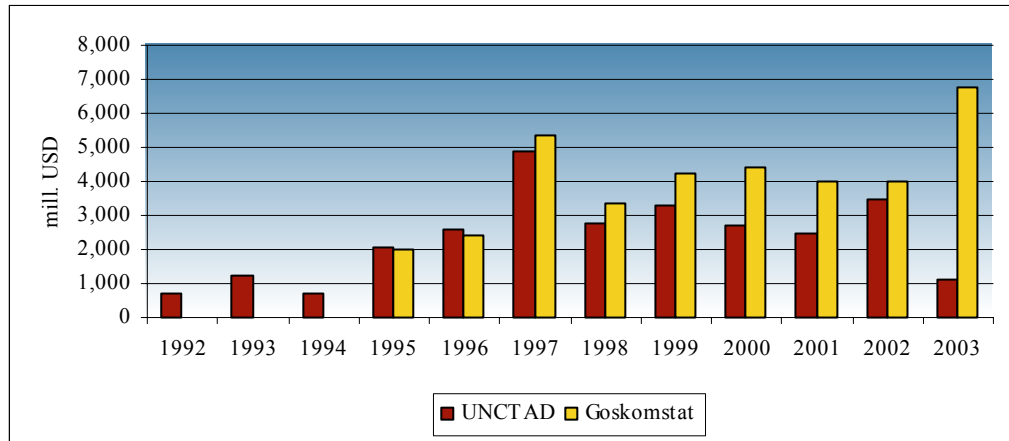
The amount of FDI can also be proportioned against GDP. According to UNCTAD (2004) the FDI inflows in Russia have corresponded to 4-7 % of the GDP, while for example in China FDI's share of GDP is much higher (over 10%).

In the Russian case it should be noted, that a large share of FDI inflows can be classified as repatriated flight capital originating in such offshore centers as Cyprus, where many Russian companies have registered subsidiaries. Russia has indeed been suffering from a massive capital flight. In 1995-1996 capital flight appears to have been equivalent to roughly 3% of GDP, rising to 13% in 1998 and declining to 7% in 2001. In 2003 there has been showing light at the end of the tunnel: net capital flows have turned positive for the first time since the beginning of the transition. This can be considered a sign of growing trust in the domestic market on behalf of the Russian companies. The capital flight was originally triggered by the instability of the economy, but as the economy has become more stable, it still does not offer a sufficient amount of viable investment opportunities. Domestic banks concentrate on accumulating excess reserves instead of lending to the industrial sector. Capital controls have proved powerless in restricting the capital flight, and the authorities now try to address the root causes of the capital flight and at the same gradually liberalize the capital account. (Economist Intelligence Unit 2004, pp. 54-55)

The yearly fluctuations of the Russian FDI inflow are depicted in Figure 9. Both Goskomstat and UNCTAD data is included in the figure.

Since the mid-1990s the annual FDI inflow to Russia has been over 2 billion USD. The figure of UNCTAD for the year 2003 is not up-to-date, and is thus so small. A clear trend in the FDI inflows cannot be observed. In 1998 the FDI inflows were held back by the ruble crisis, and according to Goskomstat the level

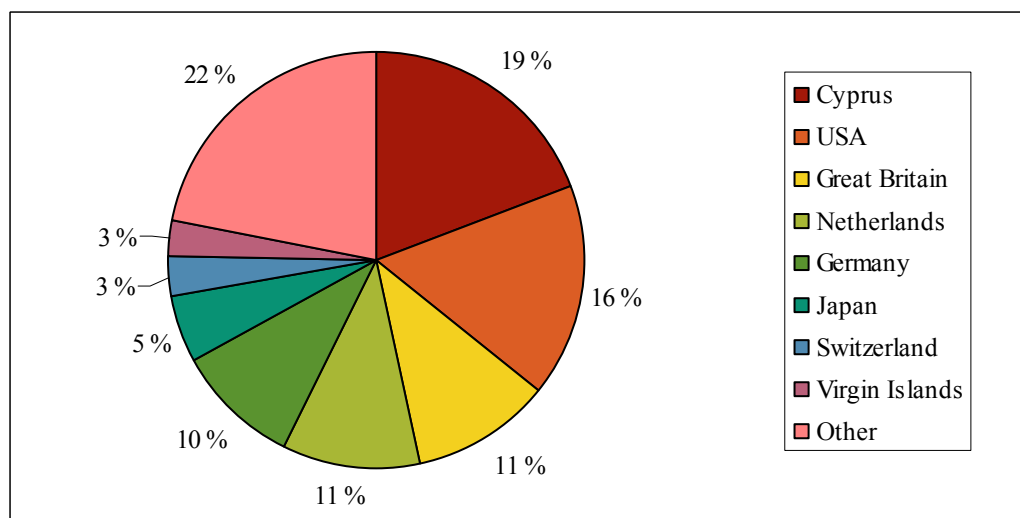
of 1997 was not exceeded until 2003. Between 1999 and 2002 annual FDI inflows remained at the level of 4 billion USD.



**Figure 9. Russian FDI inflow (UNCTAD 2004a, Goskomstat 2004)**

## 5.2 FDI Sources

The distribution of the Russian FDI stock by home countries is presented in Figure 10.



**Figure 10. Home countries of the Russian FDI stock 2003 (Goskomstat 2004)**

The total amount of inward FDI stock in Russia in 2003 was approximately 26.1 billion USD. Almost one fifth of the stock originates in Cyprus. United States is number two in the country of origin comparison and Great Britain and Netherlands share the third position. Germany, Japan, Switzerland and Virgin Islands are other large investors.

The countries of origin of annual inward flows of FDI are presented in Table 7. The changes in the group of the most important investors prove that the Russian capital is returning to the country. Cyprus appeared in the top-10 listing of investing countries in 1999, and since 2001 it has been among the four largest investors. Virgin Islands, another off-shore destination for Russian capital flight, rose to the top-10 in 2001.

**Table 7. Countries of origin of Russian inward FDI flows (Goskomstat 2004)**

	1995	2001	2002
FDI inflow, total (mill. USD)	2,020	3,980	4,002
Major investor countries, share of total FDI			
USA	32%	27%	16%
Cyprus	...	13%	14%
Netherlands	2%	14%	13%
Germany	10%	12%	10%
UK	4%	7%	8%
Japan	1%	5%	7%
Finland	...	...	4%
Virgin Islands	...	2%	3%
Luxemburg	...	...	3%
Switzerland	10%	1%	2%
France	5%	1%	1%
Austria	3%	1%	...
Belgium	4%	...	...
Sweden	3%	...	...
Others	26%	17%	19%
Total	100%	100%	100%

### 5.3 Sectoral Distribution of FDI

The sectoral distribution of the 2003 FDI inflow to Russia is presented in Table 8. Foreign investments in Russia have been directed to such sectors that have excelled in exports or have been boosted by domestic demand. In 2003 half of the investments were made in industry and one fifth in retail and catering. Other sectors' shares are rather small. Among different industrial branches fuel production has been most successful in attracting foreign capital, its share of the total FDI inflow in 2003 was 28%.

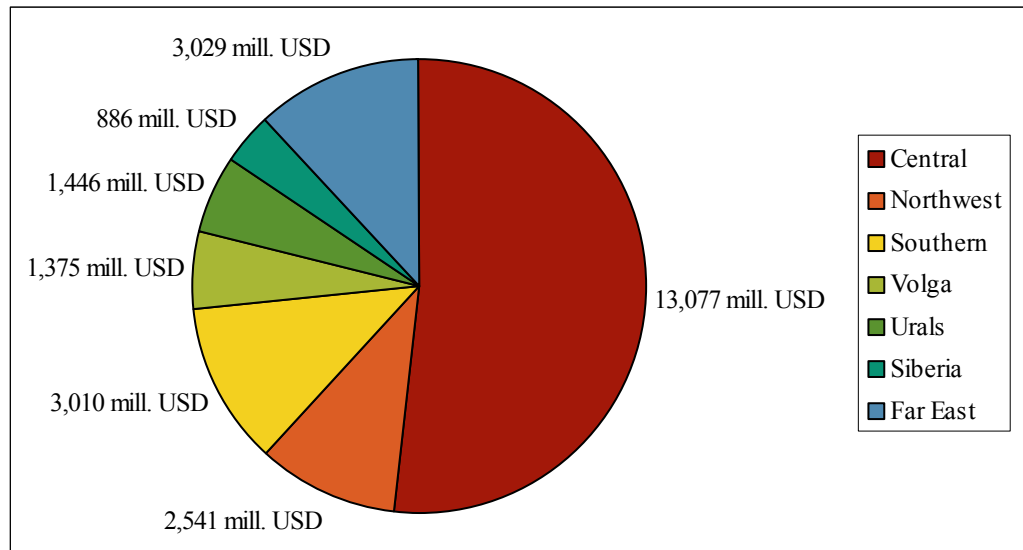
**Table 8. The sectoral distribution of FDI in Russia (Goskomstat 2004)**

	mill. USD	%
Industry, including	3,420	50
electricity production	9	0
fuel industry	1,917	28
ferrous metallurgy	84	1
non-ferrous metallurgy	47	1
chemical and petrochemical industry	96	1
mechanical engineering	323	5
forest industry and wood processing	315	5
food industry	345	5
Construction	142	2
Agriculture	56	1
Transport	165	2
Telecommunications	96	1
Retail and catering	1,617	24
Finance and insurance sector	186	3
Other sectors	995	15
<i>Total</i>	<i>6,781</i>	<i>100</i>

### 5.4 Regional Distribution of FDI

As Liuhto & al. (2004, p. 71) point out, foreign direct investments are extremely unevenly distributed among the Russian regions. The regional distribution of FDI in Russia is discussed in the following. In this context the Goskomstat data on FDI is used, since it is the only data set in which the regional division is made.

To compare the performance of the federal districts in the field of attracting FDI, the annual FDI inflows of different federal districts between 1997 and 2002 were summed up. The distribution of FDI between the federal districts is illustrated in Figure 11.

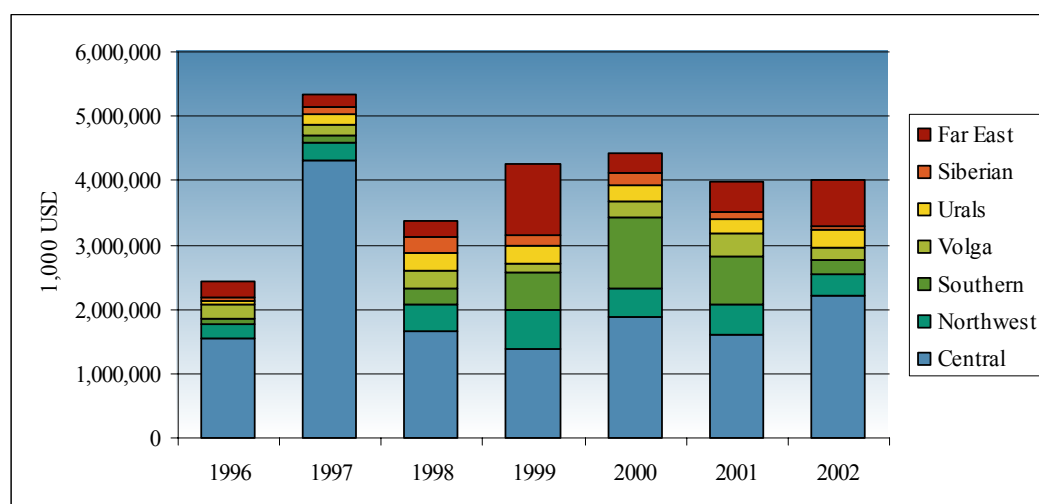


**Figure 11. Regional distribution of the cumulative Russian FDI inflow 1997-2002 (Goskomstat 2004)**

The total amount of accumulated FDI inflows to Russia between 1997 and 2002 was roughly 25 billion USD. 52% of this went to the Central FD. Compared to the Central FD's share of the Russian population (26%) and GDP (34%) its share of the FDI inflows seems disproportionate. Other districts that have succeeded in attracting foreign capital include The Northwest, Southern and Far East FDs, each of which counts for around one tenth of the Russian FDI inflow. The Northwest FD's share of the Russian FDI is in proportion with its share of the Russian population (10%) and GDP (10%). The Southern FD should have managed to attract more FDI if population is used as a measure; however its share of FDI exceeds its contribution to GDP (8%). Far East is the opposite of the Southern FD, since it has gotten more FDI than its share of the Russian population (5%) and GDP (5%) would allow one to presume. Volga, Urals, and Siberia FDs have attracted 5, 6 and 3% of the Russian inward FDI, respectively. These three regions' share of the FDI in no way mirrors their share of the Russian population

and GDP. The Volga FD in particular has not lived up to its potential when it comes to FDI: its share of the country's population is 22% and it counts for 17% of the country's GDP. Nevertheless Volga FD's share of the FDI inflows is a meager 5%.

The dynamics of the FDI orientation between the Russian regions are illustrated in Figure 12. The Central FD's position as number one target for FDI weakened in the end of the 1990s, but in the year 2002 it has gotten stronger again.



**Figure 12. Dynamics of the Russian FDI inflow's regional distribution (Goskomstat 2004)**

The division of FDI inside the federal districts is by no means even. The differences in figures describing the FDI inflows are immense between different federal subjects. It would be impossible to discuss each of the 89 regions individually, and thus only the best in the field of FDI are given a closer look.

Table 9 shows the 10 most successful subjects in attracting foreign capital in terms of absolute figures.

In absolute numbers Moscow city's accumulated FDI inflows are worth 9,845 million USD. No other region comes close to this figure, and it seems that

Moscow is only strengthening its position. In 1998 its share of the total Russian FDI inflow was roughly 24%, in 2002 the corresponding share was 38%. (Goskomstat 2004) Sakhalin oblast which is number two in the ranking has been the target of 2,504 million US dollars between 1997 and 2002. All seven federal districts are represented in the top-10 of FDI attracting regions. Most of the top regions surround a city with more than million inhabitants. Thus it seems that high urbanization rate attracts foreign investors in Russia. Other top regions possess abundant natural resources. Thus the existence of markets and on the other hand the existence of natural resources seems to have played an important role in the selection of investment location.

**Table 9. Regions with largest cumulative FDI inflow 1997-2002  
(Goskomstat 2004)**

Rank	Region	Federal District	Accumulated FDI 1997-2002, mill. USD
1	Moscow city	Central	9,845
2	Sakhalin oblast	Far East	2,504
3	Krasnodar krai	Southern	2,399
4	Moscow oblast	Central	2,206
5	St. Petersburg	Northwest	1,026
6	Leningrad oblast	Northwest	961
7	Samara oblast	Volga	605
8	Novosibirsk oblast	Siberia	582
9	Sverdlovsk oblast	Ural	541
10	Yamal-Nenets ao.	Ural	350

Inward FDI stock relative to population is presented in Table 10. If the accumulated FDI is divided by the region's population, the far eastern region of Sakhalin rises above the others. Behind the region's relative success lie its natural resources and small population. In the relative ranking of the regions there are other regions with similar backgrounds to Sakhalin Oblast's. These regions include the Magadan Oblast, Koryak AO and Yamal-Nenets AO.

The reasons behind the attractiveness of the Moscow City in the eyes of foreign investors include its large population as well as its position as Russia's leading business center. It should however be kept in mind, that some investments

registered to Moscow might actually be targeted to other Russian regions, since almost all major companies have their headquarters in Moscow. Moscow Oblast is one of the top industrial regions of the country thus attracting lots of FDI. (Liuhto & al. 2004, pp. 75-76)

**Table 10. Regions with largest relative cumulative FDI 1997-2002  
(Goskomstat, author's calculations)**

Rank	Region	Federal District	Accumulated FDI 1997-2002 / capita, USD
1	Sakhalin oblast	Far East	4,586
2	Moscow city	Central	951
3	Magadan oblast	Far East	802
4	Yamal-Nenets ao.	Urals	691
5	Leningrad oblast	Northwest	575
6	Krasnodar krai	Southern	468
7	Koryak ao	Far East	343
8	Moscow oblast	Central	333
9	Kaluga oblast	Central	287
10	St. Petersburg	Northwest	220

Of the regions of the Southern Federal District Krasnodar Krai is the only one to reach the top-10 of FDI targets. Krasnodar has been the interest of foreign investors due to its favorable location on the Black Sea. The ports by the Black Sea are specialized in exporting oil and gas products and the major infrastructure projects connected with the oil and gas sector have offered investment opportunities for foreign companies. (Liuhto & al. 2004, p. 75)

Two subjects of the Northwest FD appear in the top-10: the City of St. Petersburg and Leningrad Oblast. Both of these regions have a flourishing industrial sector, which has also attracted foreign investors. Telecommunications, wholesale, public catering and transportation have also received substantial FDI inflows. (Liuhto & al. 2004)

Samara region is the only region from the Volga FD to make the top-10. Its strengths lie in machine building and metal work industry. The Ural FD has its vast natural resources to thank for its success in attracting FDI. Tyumen Oblast,

which includes the autonomous okrugs of Khanty-Mansii and Yamal-Nenets, possesses roughly 90% of the gas and over 60% of the oil reserves of the Russian Federation. Sverdlovsk oblast possesses significant mineral resources.

Of the Siberian regions Novosibirsk is the only one to appear in the top-10 of FDI targets. Novosibirsk's success is based on several sectors, which include machine building, food industry, power industry, agriculture, trade and transportation. Novosibirsk also serves as a processing and distribution center for the goods coming from the neighboring regions with abundant natural resources. (Liuhto & al. 2004, pp. 76-78)

## **5.5 The Russian Investment Climate**

Any country has both advantages and disadvantages in the eyes of a foreign investor. This holds true in the Russian case as well.

The advantages of the Russian Federation well from its 145 million population and resource base. Russia possesses vast oil, gas, mineral, and timber resources, and thus attracts investors with resource-seeking motives and extractive investments. In addition Russia has plenty of educated human capital. (Tiusanen & al. 2002, p. 131) Statistics presented in the previous chapter also support this assumption, as 28% of the 2003 FDI inflow went to fuel industry and 5% to forest industry. However Russia has knowingly limited the access of large multinational companies to the core of the Russian extractive industries (Lappeenranta University of Technology 2001, p. 54). The Russian energy sector has nevertheless slowly started to open up for foreign investors (Liuhto & al. 2004, p. 68). A large part of the energy sector's production is being exported and the cluster is becoming increasingly integrated into the global network (Hernesniemi & Dudarev 2003).

The large and unsatisfied Russian market attracts market-seeking investors. It should anyhow be kept in mind that in Russia the income distribution is very uneven both between households as well as between different parts of the country. (Tiusanen & al. 2002, p. 18) According to a survey conducted by the European Business Club (2003, p. 7) the large size of the Russian market has been the dominant motive for investment among the respondent companies. The fact that Russian and foreign companies often compete in different segments of the market makes the Russian markets even more attractive: local competition is not an issue. Foreign companies often focus on high-end products. (European Business Club 2003, p. 17)

FDI became an interesting option for foreign companies willing to enter the Russian market when the ruble was devaluated in 1998, since the devaluation hampered exporting to Russia. Unpredictable import regulations, high import duties and time-consuming customs formalities have also made FDI a more attractive option. (Moijanen 2002b)

A foreign company typically first establishes itself as an exporter to Russia, and after that, as the company gains better understanding of the market, the decision to start producing locally emerges. In many cases the trade-off between investing in local production and imports has been resolved by diversifying between these two. Most of the FDI made in production have been greenfield investments. (European Business Club 2003, p. 12, 17)

The Russian political climate has not always been too favorable for foreign investors. Politicians have feared that foreign investors might exploit local resources and take advantage of Russia. (Fabry & Zeghni 2002) It however seems that in president Putin's era some improvement in the attitudes towards foreign investors can be observed. A general willingness to improve the business environment via institutional reforms has emerged. (Tiusanen & al. 2002, p. 26)

European Business Club (2003, p. 8) has studied the most critical barriers to investment in the eyes of foreign companies. According to its survey top barriers are inefficient bureaucracy (81% of companies considered it a critical barrier), corruption (65%), the unsatisfactory work of customs (60%), customs legislation (54%), and poor work by courts (45%). These factors were followed by tax legislation, underdeveloped infrastructure, unfair competition, poor corporate governance, insufficient protection of intellectual property rights, underdeveloped banking system, and the lack of International Accounting Standards.

The absence of adequate protection of property rights is a significant difficulty faced by foreign investors. This situation stems from the preferences of the Russian oligarchs. The oligarchs have favored rent-oriented structures and consequently they have preferred relatively poor protection of property rights. This has forced foreign as well as domestic investors to invest in private protection of property rights. (Frye & Shleifer 1997)

The lack of clear ownership rights has been one of the key problems in Russia. In many emerging markets it is practically impossible to register landed property which forces poor people to operate in the informal sector outside the law. As a consequence properties cannot be mortgaged to provide capital for the expansion need of small businesses. Selling the property is also impossible. (Tiusanen & al. 2002, p. 26)

The market penetration of small- and medium-sized enterprises might be hindered by the small size of the corresponding Russian company group. Smaller companies tend to be focused on handling one specific part of the supply chain. In Russia they might find it difficult to find local companies to handle the other parts of the supply chain, as the large companies that cover the whole supply chain dominate the business sector. (Komulainen & al. 2004)

In recent years international risk rating organizations have been lowering Russia's risk rating (Moijanen 2002b). The economic achievements of the Putin era have

been considered indisputable. Business leaders and investors have started to gain more confidence in the economy and Russia's political leadership has recognized the importance of improving the country's investment climate. (American Chamber of Commerce in Russia 2004, p. 2, 6) Putin has for example changed the country's taxation system rather thoroughly, which has increased the stability of the business environment. The new system will be implemented by the end of 2006, and thereafter no significant changes in the system will take place. (Komulainen & al. 2004)

It has been suggested (Cullison 2004, Arvedlund & Timmons 2004) that in 2004 the positive development of the investment climate has been hindered by Kremlin's tightening grip on politics and heights of industry. The arrests of Russia's leading oligarchs have raised fears that the Russian business life is becoming increasingly state-controlled. However it seems that the renationalizing of oil and gas is not on Putin's agenda. Instead he seems to be more interested in fighting the increasing power of the oligarchs. Anyhow it is obvious that at least the energy issues have become rather politicized in recent years. (Lehane 2004)

## **5.6 Finnish Companies as Investors in Russia**

According to the bank of Finland (2004) the value of Finnish investments in Russia was 342 million euros in 2003. The actual figure however is closer to 1.5 billion euros if the re-invested profits are included in the estimate (Teollisuus ja Työnantajat 2003, p. 32). However the Finnish investments to Russia have been rather minor (Liuhto & al. 2004, p. 79).

In recent years the Finnish companies have become more interested in doing business in Russia. Russia's share of Finnish companies' staff and turnover abroad has been increasing, and the number of Finnish companies' employees in Russia has quadrupled between 1997 and 2002. (Teollisuus ja Työnantajat 2003, p. 19, 28) The development of Finnish companies' operations in Russia is

presented in Table 11. Even though Finnish companies are increasing their operations in Russia, Russia's share of the total amount of operations abroad is still small.

**Table 11. The staff and turnover of Finnish companies' foreign subsidiaries and branches in Russia (Bank of Finland 2004, 2003, 2002)**

		2000	2001	2002	2003
Employees abroad	In Russia	6,920	6,300	9,512	9,886
	Total	288,087	315,062	333,733	331,203
	Russia's share of total	2.4%	2.0%	2.9%	3.0%
Turnover abroad (mill. EUR)	In Russia	471	923	1,003	1,074
	Total	111,699	116,667	128,288	113,915
	Share of total	0.4%	0.8%	0.8%	0.9%

Regionally speaking the Finnish investments in Russia have been concentrated in St. Petersburg and the rest of the Northwest Russia. In this part of the country Finland is the biggest investor if measured by the number of joint ventures. Other popular regions among the Finnish companies include Moscow, Moscow oblast, Nizhnii Novgorod and Perm. (Finpro 2004)

Russia has attracted especially Finnish companies operating in the forest and food sectors. It should also be noted that according to a company survey the share of production workers in the affiliates of the Finnish companies in Russia has increased. (Teollisuus ja Työnantajat 2003, p. 7, 30). Thus it seems that Finnish companies are increasing their manufacturing operations in Russia.

In forest and paper industry Finland is among the most significant foreign direct investors in Russia. In 2003 Finnish companies invested 79 million USD in forest and paper industry, and were thus the second largest investor in this field. Finland's share of the investments made in this particular sector was 21.5%. (Goskomstat 2004) StoraEnso and UPM-Kymmene are among the Finnish forest companies that have made direct investments in Russia. Both of these companies have sawmills in Russia, and StoraEnso has also invested in cardboard

production. Metsäliitto owns 44% of a Russian wood supplier, and Botnia is about to set up sawmills in Russia. Novgorod region has been favored among the Finnish forest companies, but they also operate in Leningrad, Kaluga, and Vologda regions as well as in Nizhnii Novgorod. (Finpro 2004)

Table 13 shows how many companies with Finnish capital are operating and what their share of the total number of companies with foreign capital is in each of the federal districts. It seems that the geographical proximity is an important factor in Finnish companies, since over half of the Finnish companies operating in Russia operate in the Northwest FD. Companies from other countries have obviously become interested in the Northwest FD as well, as Finnish companies share of total number of companies with foreign capital has decreased. The number of companies with Finnish capital has started to decrease in the Central Federal District, maybe as a consequence of increasing Russian and foreign competition. In other federal districts no dramatic changes have taken place when it comes to Finnish companies' activities.

**Table 12. Finnish companies in the Russian Federal Districts**  
(Goskomstat 2003)

Federal District	1998		2000		2002	
	Finnish	Finnish of total (%)	Finnish	Finnish of total (%)	Finnish	Finnish of total (%)
Central	138	2.1	122	1.9	95	1.3
Moscow + Moscow obl.	128	2.1	112	1.9	86	1.3
Northwest	310	18.7	448	16.1	429	13.5
SPb + Leningrad obl.	254	25.8	378	19.5	353	15.7
Southern	8	1.3	9	1.1	9	1.1
Volga	19	2.6	14	1.9	15	2.1
Ural	8	1.8	9	2.1	9	1.9
Siberian	5	1.0	6	1.1	7	1.2
Far East	4	0.7	4	0.6	5	0.7
<i>Total</i>	<i>492</i>	<i>4.4</i>	<i>612</i>	<i>4.9</i>	<i>569</i>	<i>4.1</i>

Finland and Russia have for several years been negotiating about an investment protection agreement. The purpose of such agreement would be to agree about

most-favored nation treatment and uniform treatment of companies operating in both countries. Taxation and customs legislation would be issues regulated by the investment protection agreement. (Kaasalainen 2002) The latest attempt to promulgate the agreement failed because Russia wanted to exclude forest industry from the agreement. The agreement would benefit Finnish companies in the form of abolition of double tariffs, which would mean lower energy, water and transportation prices. Repatriation of profits would also become easier with the agreement. (Finpro 2004)

In addition to the lack of investment protection agreement Finnish investors see the arbitrariness and slowness of the Russian bureaucracy as major risks. General legislative uncertainty is also commonly seen as a problem in Russia. (Teollisuus ja työnantajat 2003, p. 22)

## **6 SURVEY**

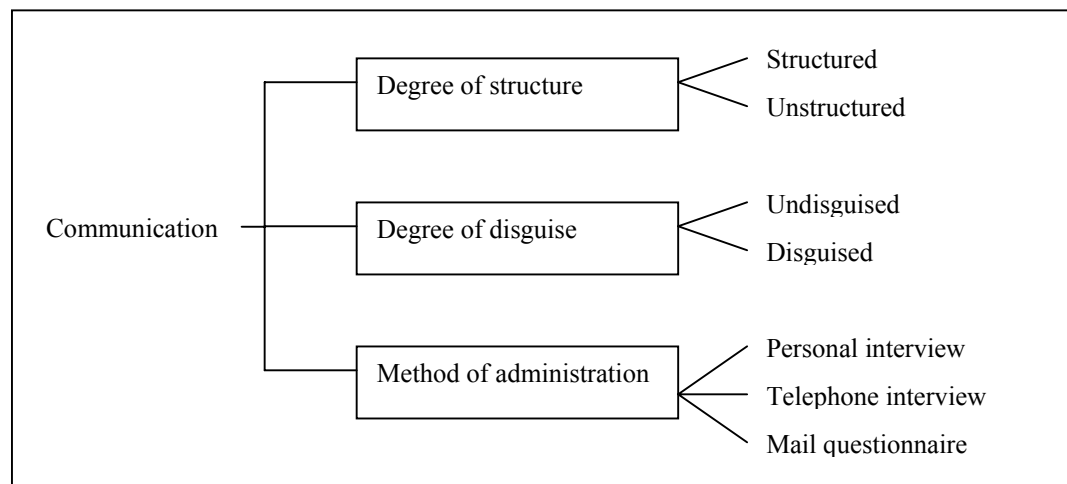
If the information needed to solve a research problem cannot be found in existing documents, the research must depend on primary data, which is collected specifically for the study (Churchill 1995, p. 347). The process to conduct the survey used to collect empirical data for this study is reviewed in this chapter. Firstly the selection of the data collection method and the design of the questionnaire are given a closer look. The questionnaire used in this study will also be presented. Secondly the sample selection and data collection process are reviewed. Finally the analysis methods applied in the analysis stage are presented.

### **6.1 Design of the Data Collection Method and Forms**

The two basic means of obtaining primary data are communication and observation. Communication involves respondents' direct questioning with the help of a questionnaire, while observation means that the situation of interest is checked and the relevant findings are recorded. (Churchill 1995, p. 347)

When attitudes, awareness, knowledge, intentions, or motivation are measured, communication methods must be used (Churchill 1995, p. 392). In this study companies are asked to tell how they weigh different factors in their decision-making. The weighting of different factors is a sort of a mixture of attitudes, knowledge, motivations and intentions. Thus they are used in this specific research, and the following remarks concerning questionnaire formulation based on literature concentrate on communications methods as well.

Communication methods can be further classified according to several factors. The classification is presented in Figure 13.



**Figure 13. Classification of communication methods (Churchill 1995, p. 392)**

The structure of the questionnaire refers to the degree of standardization imposed on the questionnaire. In a highly structured questionnaire the questions and the responses permitted are predetermined, while in an unstructured questionnaire the questions are loosely predetermined and the respondents are encouraged to answer in their own words. A questionnaire with predetermined questions and open-ended responses can be considered an intermediate form of structure. The advantages of a highly structured questionnaire include comparability, reliability and clarity. An unstructured questionnaire can in some cases provide answers with better validity, since in fixed-alternative questions the answers may not accurately reflect the true state of affairs. Fixed-alternative questions should thus be used when possible replies are well known, limited in number, and clear-cut. (Churchill 1995, pp. 351-352)

Degree of disguise refers to the amount of knowledge about the purpose of the study that is given to the respondent. Hiding the purpose of the research is important when the respondent may be tempted to give the socially accepted response on sensitive issues. (Churchill 1995, p. 393)

Questionnaires can also be classified by their method of administration. The three main methods of administration are mail, phone and personal interview. All of these methods have their pros and cons. Postal interviewing enables the coverage

of a large geographic area at a relatively low cost. However the respondent will not be able to query the meaning of the questions. A low level of response is also a common problem in postal surveys. Telephone interviews also provide a geographical advantage at a relatively low cost, and their response rates tend to be higher than mail surveys'. The phone however does not provide for the use of visual aids. (Moutinho & Evans 1996, pp. 26-28) Personal interviews usually guarantee a high response rate, allow clarification of unclear questions, and allow the use of unstructured questionnaires. Yet personal interviewing tends to be rather costly and time-consuming. (Churchill 1995, p. 378)

A questionnaire typically contains three types of measurement questions: administrative, classification and target questions. Administrative questions enable the identification of the respondent, interviewer, interview location and other conditions. Classification questions aim at the grouping of the respondents' answers so that patterns and differences between the groups can be revealed and studied. Target questions address the actual research problem of a study. (Cooper & Schindler 2001, pp. 333-334)

Considering the framework and the resources allocated to this specific research, postal interview was chosen as the survey method to collect primary data. It was clear that the data obtained via postal survey would be reliable enough, since the needed data was relatively simple and well structured.

The questionnaire used in this study can be found in Appendix 1. The questions included in the questionnaire are reviewed in the following.

Question number one was the only target question in the questionnaire of this research. In the first question the respondent was asked to weight the significance of seven principal and 23 secondary factors by dividing 100 points first between the principal factors and then between the secondary factors in each sub-group. Factors are presented at two levels (primary and secondary) to make answering

easier. It would be extremely difficult for the respondent to divide 100 points between 23 factors.

Factors to be included in the questionnaire were chosen based on previous research concerning the factors affecting FDI location decision at a sub-national level. These articles were reviewed in Chapter 3. In the same chapter assumptions concerning the factors effecting the FDI location decision were made (Table 3). With the help of these assumptions the factors and their effect (negative vs. positive) on a region's FDI attractiveness were chosen for the questionnaire.

Table 13 shows the factors included in the questionnaire and the indicators that were used to estimate them. The proxies will be used in the last phase of this study, the ranking of the Russian regions. The attractiveness of each of the Russian regions from the Finnish investors' perspective can be estimated as the regional value for every proxy is known and the average weighting of each factor can be calculated based on the responses. Estimators for additional labor costs and amount of corruption were not found. Thus those two factors are excluded from further analysis even though they are included in the questionnaire.

The inclusion of the low risk level as a factor attracting FDI in the case of Russia seems somewhat controversial. However the assumption here is that the foreign investors have already accepted a certain level of risk as they have decided to invest in Russia. When they are selecting a suitable location inside Russia they are expected to go for a region with low risk levels. Stable public economy and low inflation have not been mentioned in the previous studies, but they are included in this study, as they are perceived to mirror the overall stability of the business environment. Thus they could also be considered sub-factors of the risk aspect.

**Table 13. Location factors included in the questionnaire and their estimates**

<b>Principal factor</b>	<b>Sub-factor</b>	<b>Estimate</b>
Market potential	High GDP / capita	GDP / capita 2002 (RUB)
	Large population	Population 2002
	Little competition	Number of companies in the corresponding sector / population 2002
	Large number of customer companies	Total number of companies 2002
	Urbanisation and high population density	Urbanisation rate 2002 (%)
Infrastructure	High level of ICT infrastructure	Number of internet connections / 1000 people 2002
	Good transportation connections	Density of paved roads + Density of railroads 2002 (m <sup>2</sup> /km <sup>2</sup> )
	Close to Finland	Distance between Helsinki and the region's capital (km)
Costs	Low corporate tax	Amount of corporate taxes paid by companies / GDP 2002 (%)
	Low wages	Average nominal monthly wage 2002 (RUB)
	Low additional costs of labour	-
	Low unit labour cost	Average annual wage / GDP / capita 2002
Resources	High level of education	Academic students' share of the population 2002 (%)
	High unemployment rate	Unemployment rate 2002 (%)
	Rich natural resources	Expert Magazine's natural resource index 2002
	Large investments in R&D activities	R&D spending 2002 (RUB)
Risks	Low values of risk indicators	Expert Magazine's risk index 2002
	Little corruption	-
	Low interest rates	Given credits / GDP 2002 (%)
General economic factors	Previous foreign investments	Cumulative FDI inflow 1997-2002 (USD)
	Low inflation	Average annual inflation rate 2000-2002 (%)
	Large exports	Average annual exports 2000-2002 (RUB)
	Stable public economy	Regional budget surplus/deficit 2002 (RUB)

Questions 2-7 of the questionnaire are classification questions. Their topics are the line of business of the respondent's company, the number of employees in the company, the company's turnover, the motive behind the company's establishment in the Russian market, the type and location of the company's activities in Russia and the company's future plans concerning its actions in Russia. These questions are used as background variables at a further stage of the study, and include such company-specific factors that are expected to influence the weightings of the location factors.

Questions 5 and 7 are closed questions, since practically every possible answer could be included in the predetermined answers in these two cases. Questions 2, 3

and 4 are open-ended, thus giving more accurate information. It was not considered necessary to give the respondents answering alternatives in these cases, since the questions are rather specific and answering possibilities limited. Question number 6 includes both closed and open-ended elements. The question about location would have been impossible to include in closed form, since there are 89 regions in the Russian Federation.

The only administrative question included in the questionnaire is the last question concerning the e-mail address of the respondent. If the respondent wished to obtain a summary of the results of the study filling in the e-mail address was obligatory.

In the context of this study there was no need to disguise the purpose of the study from the respondents, as the research subject was not especially sensitive and the background was purely academic.

The survey documents and procedures should be tested in beforehand. Pre-testing of the questionnaire ensures that its deficiencies can be corrected in before hand. The pre-testing should be done with a personal or telephone interview. A personal interview pre-test can be implemented using either a debriefing or a protocol approach. In the debriefing approach the respondent first fills out the questionnaire and only after that gives his comments. In the protocol approach the respondent is asked to think aloud while filling out the questionnaire. (Aaker & al. 2001, p. 319)

The questionnaire was tested in one Finnish company before it was sent to the entire sample. The testing was done in a personal interview, and the protocol approach was employed. Valuable information concerning the content and technical realization of the questionnaire was obtained this way. Comments concerning the questionnaire were also received from a marketing research company and from the Finnish Russian Chamber of Commerce.

## 6.2 Sample Design and Data Collection

Sample design is an important part of the research process. There are two basic approaches to this question. One approach is to include all relevant respondents in the study, while the other is to select a sample from the total number of potential respondents. (Moutinho & Evans 1996, p. 56)

As there is no extensive register of all Finnish companies exercising business in Russia, selecting a sample was basically the only possibility.

In this case the survey was made in coordination with the Finnish-Russian Chamber of Commerce, and its target group was the members of the chamber of commerce. The chamber of commerce provided the contact information of its members. Since not all members of the chamber of commerce are commercial organizations, some of them were excluded from the sample. The final size of the sample was the above-mentioned 464.

The survey was conducted between August 10<sup>th</sup> and September 10<sup>th</sup> 2004. The questionnaire was sent out by mail on August 10<sup>th</sup>, and the companies were asked to return it in an attached return envelope by August 19<sup>th</sup>. The last answer arrived on September 10<sup>th</sup>.

The total number of answers that arrived by mail was 78. In this case the calculation of the response rate<sup>4</sup> is not quite straightforward, as the number of the so-called eligible response units in the sample is not known. Some of the members of the Finnish Russian Chamber of Commerce are not operating in Russia, and thus they were not capable of answering the questionnaire. If it were assumed that all 464 companies are operating in Russia and thus capable of participating in the study the response rate would be 17%.

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<sup>4</sup> Response rate = Number of completed answers with responding units / Number of eligible responding units in the sample (Churchill 1995, p. 662)

Four of the 78 responses were altogether rejected, since the respondents were non-profit organizations and had not filled out the questionnaire. Of the remaining 74 respondents 66 had filled out the part of the questionnaire concerning the location factors of their activities in Russia. Some of these answers were however somewhat deficient and 17 companies were asked to complete their answer via e-mail. One of the companies that had returned a deficient answer had not submitted its e-mail address. 11 of the 17 companies sent the lacking answers via e-mail, and thus the number of complete, disposable answers was 59.

Three companies reacted to the survey only by e-mail. They announced that they do not have such activities in Russia that they could base their answer on, and thus would not return the questionnaire.

Even though the original plan was to concentrate on solely foreign direct investments, companies with other kinds of business activities were also asked to answer the survey. Of the 59 complete answers 39 was submitted by companies with direct investments in Russia. Other companies had agents and representatives operating in Russia, or they were serving the Russian market via direct exporting.

### **6.3 Analysis of the Collected Data**

The analysis of the data begins with basic description of the data. The composition of the sample in the light of the classification questions is presented. The responses to the open-ended classification questions will be divided into suitable groups.

In the next phase the average weightings of the location factors are calculated for the whole sample as well as for different types of companies. Thus the answer to the main research question will be found.

The next step is studying the influence of the background variables on the weightings of the factors. For this purpose comparison of means and analysis of variance are applied. These methods are given a closer look in the following.

Comparison of means of two sets of data can be implemented with the *t*-test. The *t*-test can only be used provided that the variable is normally distributed. (Kennedy & Neville 1976, p. 205) The Mann-Whitney test is the non-parametric equivalent of the *t*-test. It should be used for comparison of means when the variable is not normally distributed. (Sachs 1974, p. 230)

The analysis of variance (ANOVA) can be used to test hypotheses concerning the mean values of more than two sub-groups (Aaker, Kumar & Day, 2001, p. 733). The use of the analysis of variance can only be used if the dependent variable has normal distribution in each combination of *x*'s. If this precondition is not fulfilled, non-parametric methods of analysis of variance, such as Kruskal-Wallis's one-way analysis of variance should be used. (Aaker & al. 2001, p. 436)

The significance level of a study tells the probability of making the wrong conclusion based on a statistical test. The most commonly used significance levels in academic research are the 1-percent level, the 5-percent level, and the 10-percent level. (Aaker & al. 2001, p. 447) In this study the 10-percent level is used, as the sample size is rather small. If a smaller significance level were chosen, the number of statistically significant results would be rather small.

## 7 RESULTS

The results of the survey are presented in this chapter. This chapter begins with the general description of the data, after which the core results (average weightings of the location factors) are presented. Finally a ranking of the Russian regions is obtained and compared to the current distribution of Finnish companies in Russia.

### 7.1 Description of the Data

The break-up of the respondent companies into different branches of the economy is illustrated in Table 14. In Table 14, as well as in other tables in this chapter, only those respondent companies that returned a completely filled out questionnaire are included. The data is presented for the whole data set as well as for FDI companies separately.

**Table 14. Sectoral distribution of respondent companies**

Sector	All respondents				Respondents with FDI in Russia			
	Company		In Russia		Company		In Russia	
<b>Manufacturing</b>	22	37 %	16	27 %	15	39 %	13	33 %
<b>Services</b>	18	31 %	17	29 %	9	23 %	8	21 %
<b>Retail</b>	9	15 %	14	24 %	7	18 %	9	23 %
<b>Construction</b>	10	17 %	11	19 %	8	21 %	9	23 %
<b>Unknown</b>	0	0 %	1	2 %	0	0 %	0	0 %
<b>Total</b>	59	100%	59	100 %	39	100 %	39	100 %

Of the 59 disposable answers over one third came from companies operating in manufacturing. Service companies were the second largest respondent group; their share of all responses was 31%. 17% of the respondents operated in construction sector and 15% in retailing. When it comes to the respondents' operations in

Russia, the distribution is more even. Only 27% mention manufacturing as their primary line of business in Russia. The share of companies operating in service sector in Russia is also 29%. Retailing does not fall far behind: nearly one fourth of the companies are mainly involved in the retailing business in Russia. 19% of the companies operate in the construction business in Russia.

Roughly 40% of the companies with foreign direct investments in Russia operate in the manufacturing sector, one fifth of them operates in the service sector, 18% in retailing, and 21% in construction. If this data is compared to the data concerning the companies' line of business in Russia, differences can be seen in the cases of manufacturing and retailing: manufacturing's share is lower and retail's share higher. This being the case it seems that there are companies among the respondents who operate in manufacturing elsewhere and only sell their production in Russia.

Table 15 shows the distribution of the respondent companies into five categories according to their turnover.

**Table 15. Turnover in respondent companies**

Turnover, 1,000 EUR	All respondents		Respondents with FDI in Russia		Respondents with other modes of operation in Russia	
	Number of companies	Share of companies (%)	Number of companies	Share of companies (%)	Number of companies	Share of companies (%)
<1,999	9	15	4	10	5	25
2,000-9,999	10	17	6	15	4	20
10,000-39,999	12	20	6	15	6	30
40,000- 199,999	12	20	11	28	1	5
>200,000	11	19	9	23	2	10
Unknown	5	9	3	8	2	10
<b>Total</b>	59	100	39	100	20	100

9 companies' turnover was less than 1,999 thousand euros, while 11 companies belonged to the largest category. Thus all size categories are fairly well

represented in the research. Most of the companies place themselves between 2,000,000 and 200,000,000 euros. Companies with FDI in Russia are somewhat larger than the average. Half of these companies have turnover worth 40,000,000 euros or more. At the same time the companies employing other modes of business tend to be smaller in size.

The size of the company can be measured not only by its turnover, but also by the number of people it employs.

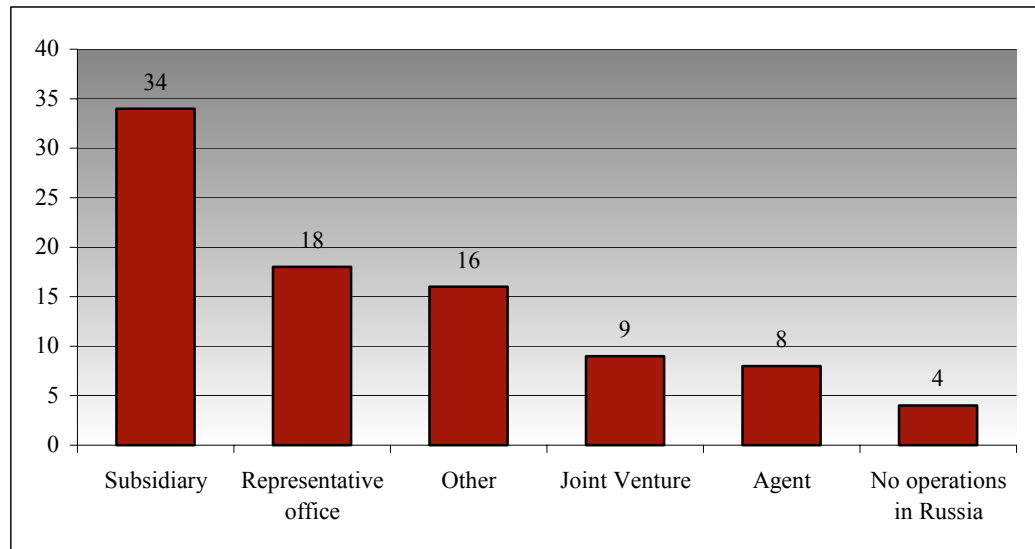
As can be seen from the Table 16, there are 16 companies among the respondents who employed over 500 people. 7 companies have less than 10 employees. The relatively large size of the respondent companies could be explained by the fact the companies who invest and operate abroad are rather large than small.

**Table 16. Number of employees in respondent companies**

Number of employees	All respondents		Respondents with FDI in Russia		Respondents with other modes of operation in Russia	
	Number of companies	Share of companies (%)	Number of companies	Share of companies (%)	Number of companies	Share of companies (%)
<b>0 to 9</b>	7	12	1	3	6	30
<b>10 to 19</b>	9	15	6	15	3	15
<b>50 to 99</b>	9	15	6	15	3	15
<b>100 to 499</b>	16	27	10	26	6	30
<b>over 500</b>	16	27	15	39	1	5
<b>Unknown</b>	2	3	1	3	1	5
<b>Total</b>	59	100	39	100	20	100

As the comparison of turnover figures already showed, the companies with direct investments in Russia are larger than the average respondent company. 39% of them employed more than 500 people. Of the respondents companies with no FDI in Russia one third employed less than 10 people, and only one had more than 500 employees.

The distribution of the respondents' operation methods is illustrated in Figure 14. All disposable answers (59) are included in the figure.



**Figure 14. Respondents' operation methods in Russia**

Subsidiary was by far the most common mode of operation among the respondents. The phrasing of the questionnaire, which mentions that FDI is the main subject of the research, has probably encouraged companies with subsidiaries to answer the survey. The number of respondents with subsidiaries in Russia was 34, while 9 companies participate in a joint venture in Russia. Four companies were involved in both a subsidiary and a joint venture. 18 companies have a representative office in Russia and agents represent 8 companies. 13 companies describe their mode of operation in Russia as “other”, which in most cases meant that the respondent is exporting its products to Russia. One respondent was not operating in Russia; however this company is planning to launch operations in Russia, and it is thus included in the analysis. Several companies utilize more than one mode of operation in Russia.

The locations of the investments that the respondents have based their answer on are presented in Table 17. St. Petersburg seems to be by far the most location for Finnish companies. 41% of the 59 respondent companies operate in St.

Petersburg, while one fifth operates in Moscow City. St. Petersburg is even more popular among the companies with FDI. Only three companies out of 59 operate outside Moscow City and North-West FD.

**Table 17. Locations of the most recently launched operations**

Location	All respondents		Respondents with FDI in Russia		Respondents with other modes of operation in Russia	
	Number of companies	Share of companies (%)	Number of companies	Share of companies (%)	Number of companies	Share of companies (%)
St. Petersburg	24	41	18	46	6	30
Moscow City	12	20	12	31	0	0
North-West FD (excl. SPb)	4	7	3	8	1	
Other	3	5	3	8	0	5
Unknown / not operating in Russia	16	27	3	8	13	65
<i>Total</i>	59	100	39	100	20	100

The primary motives of the companies for operating in Russia are presented in Table 18. The distribution of motives is presented for both the data as a whole as well as for those companies with and without direct investments in Russia.

**Table 18. Respondents' primary motives for operating in Russia**

Primary motive for FDI	All respondents		Respondents with FDI in Russia		Respondents with other modes of operation in Russia	
	Number of companies	Share of companies (%)	Number of companies	Share of companies (%)	Number of companies	Share of companies (%)
<b>Market seeking</b>	43	73	31	80	12	60
<b>Resource seeking</b>	1	2	1	3	0	0
<b>Efficiency seeking</b>	5	9	3	8	2	10
<b>Strategic asset seeking</b>	6	10	4	10	2	10
<b>Other</b>	3	5	0	0	3	15
<b>Unknown</b>	1	2	0	0	1	5
<i>Total</i>	59	100	39	100	20	100

Majority (73%) of the respondents has been attracted to Russia by its markets. Resources have been the primary reason for operating in Russia in only one company, while cost efficiency and strategic asset seeking each acted as main motivators in roughly one tenth of the companies. Three companies referred to other reasons as their primary motive and one respondent did not answer the question.

When it comes to companies with direct investments in Russia 80% of them considered markets as their primary motive. 9% of the companies have invested in Russia because of efficiency benefits and strategic reasons are behind the investment decision in 10% of the companies.

Markets have been the primary motive for operating in Russia in 60% of those companies with no FDI in Russia. This figure is 20 per cent units less than the figure for companies with FDI in Russia. However as the number of companies with other modes of business in Russia is rather small (20), the results cannot be considered too decisive.

Significant differences in the primary motives were not found neither between the companies operating in different sectors nor between different-sized companies.

Table 19 gives an idea of the companies' future plans. An overwhelming majority (81%) of the respondents is going to increase their activities in Russia within the next five years. None of the companies are planning to suspend their activities and 7% of the respondents were planning to set up their first business activities in Russia. Only two companies have intended to decrease their operations in Russia.

Companies with FDI in Russia are even more optimistic. 85% of them are going to increase their operations in Russia, while only one company is going to decrease them.

**Table 19. Future plans of the respondent companies**

Future plans	All respondents		Respondents with FDI in Russia		Respondents with other modes of operation in Russia	
	Number of companies	Share of companies (%)	Number of companies	Share of companies (%)	Number of companies	Share of companies (%)
<b>Start operations</b>	4	7	1	3	3	15
<b>Increase operations</b>	48	81	33	85	15	75
<b>Keep operations unchanged</b>	5	9	4	10	1	5
<b>Decrease operations</b>	2	3	1	3	1	5
<b>Shut down operations</b>	0	0	0	0	0	0
<b>Total</b>	59	100	39	100	20	20

Manufacturing companies have taken the most positive stance concerning business in Russia, as they were all planning to either increase their operations or start operating in Russia. The company size does not seem to influence the company's future plans.

Respondents were also asked to tell when their operations in Russia have been established. The results of this question are presented in Table 20. Only 3 companies have been operating in Russia prior to the collapse of the Soviet Union. All of these companies have direct investments in Russia. 18 companies have entered Russia in the beginning of the 1990s, while 13 companies have waited until the end of the decade. Rather large share (15 companies) of the respondents has started operating in Russia as recently as the beginning of the new millennium. On average companies with FDI in Russia have been operating in Russia longer than the respondents overall. This observation somewhat support the Uppsala model of internationalization.

**Table 20. The year the first investment was made in Russia**

Year	All respondents		Respondents with FDI in Russia		Respondents with other modes of operation in Russia	
	Number of companies	Share of companies (%)	Number of companies	Share of companies (%)	Number of companies	Share of companies (%)
-1990	3	5	3	8	0	0
1991-1995	18	31	15	39	3	15
1996-2000	13	22	11	28	2	10
2001-	15	25	10	26	5	25
Unknown	10	17	0	0	10	50
<b>Total</b>	59	100	39	100	20	100

## 7.2 Weightings of the Location Factors

The core results of the survey are presented in the following. At the same time the main research question is answered. The average weightings of the seven primary factors are presented first, followed by the presentation of the average weightings of the sub-factors.

The assumptions presented in Chapter 3.2 cannot simply be proven to be correct or incorrect due to the nature of the survey. The respondents were not asked to tell whether the factors presented in the questionnaire influence their decision. Instead they gave relative weightings to the factors. Thus the results cannot be interpreted in a black-and-white manner. The weighting of each factor should be assessed in proportion to the weightings of other factors.

### 7.2.1 Primary Factors

The first question of the questionnaire was the only target question included in the survey. The answers of this question are presented in this chapter.

The weighting of the seven principal factors affecting the location decision are depicted in Table 21. Market potential clearly rises above other factors supporting the argument that foreign investors are after Eastern-European markets.

**Table 21. Weightings of the primary factors**

<b>Factor</b>	<b>Total*</b>	<b>Companies with FDI**</b>	<b>Companies with other modes of operation***</b>
Market potential	36%	38%	35%
Infrastructure	15%	13%	16%
Costs	12%	13%	11%
Resources	13%	13%	13%
Risks	9%	8%	10%
General economic factors	9%	8%	12%
Other factors	6%	8%	3%
<i>Total</i>	<i>100%</i>	<i>100%</i>	<i>100%</i>

\*n=59, \*\*n=39, \*\*\*n=20

Market potential's high significance implies that even though Eastern-Europe is often considered to be the source of cheap labor force and other resources, foreign investors in Russia are more interested in the market potential. This seems to be true at least in the case of Finnish companies. The relatively small weighting of the resource-factor is somewhat surprising, as Russia is famous for its endless natural and human resources. The composition of the sample might to some extent distort the result, but it still seems that Finnish companies have not gone to Russia in search of resources.

All in all it seems that the selection of those factors that were to be included in the questionnaire was rather successful. All predetermined primary factors weigh roughly 10% or more in the decision-making process and only 6% of the decision is based on other factors. This result should however be interpreted with caution, as respondents are often deterred by open-ended questions. The respondents might have considered coming up with additional factors too laborious.

The differences between the weightings of the factors in companies with FDI in Russia and companies with other business modes are rather small. These differences will be further investigated in Chapter 7.3.

**Table 22. Weightings of the primary factors in different sectors**

<b>Factor</b>	<b>Manufacturing*</b>	<b>Retail**</b>	<b>Services***</b>	<b>Construction****</b>
Market potential	39%	31%	37%	44%
Infrastructure	14%	16%	13%	13%
Costs	12%	13%	16%	9%
Resources	11%	16%	13%	12%
Risks	10%	10%	6%	7%
General economic factors	8%	10%	10%	11%
Other factors	7%	6%	5%	5%
<i>Total</i>	<i>100%</i>	<i>100%</i>	<i>100%</i>	<i>100%</i>

\*n=22, \*\*n=18, \*\*\*n=9, \*\*\*\*n=10

There are some differences in how companies in different sectors weight the factors affecting the location decision (Table 22). Surprisingly retailing companies give market potential smaller than average weighting and on the other hand appreciate good infrastructure and availability of resources. The significance of market potential seems to be highest in the construction sector. The significance of these differences between different sectors is tested in Chapter 7.3.

**Table 23. Development of the primary factor weightings**

<b>Factor</b>	<b>FDI made</b>		
	<b>Between 1991 and 1995*</b>	<b>Between 1996 and 2000**</b>	<b>After 2001***</b>
Market potential	40%	35%	39%
Infrastructure	17%	13%	14%
Costs	12%	13%	11%
Resources	17%	10%	12%
Risks	6%	11%	6%
General economic factors	7%	13%	7%
Other factors	1%	5%	11%
<i>Total</i>	<i>100%</i>	<i>100%</i>	<i>100%</i>

\*n=10, \*\*n=8, \*\*\*n=19

No strong trends can be detected in the development of the weightings of the location factors over time (Table 23). Infrastructure has lost some of its

significance, maybe due to the overall improvement of both traditional transportation connections as well as telecommunications. The weighting of other factors has grown from 1% to 11%. This development is however difficult to explain due to the versatility of the factors mentioned in the “other factors” category. The significance of risks and general economic factors in decision-making has been largest between the years 1996 and 2000: the economic crisis of 1998 might have increased investors’ awareness of economic and other types of risks during this specific period.

### **7.2.2 Secondary Factors**

Table 24 shows the weighted means of all sub-factors. Unsurprisingly the number of customer companies is the single most important factor in the selection of a suitable location for business activities. Large population also gets a rather high weighting among the respondents. Sub-factors bundled under cost aspects rank surprisingly low in the overall comparison. Low wages form only 5% of the basis of the location decision, even though labor costs were the second most often mentioned location factor in previous studies.

Good infrastructure was the most often mentioned location factor in previous studies, and Finnish companies also rank the proximity of Finland and good transportation connections rather high.

Six factors count for less than 2% of the decision-making criteria. These factors are stable public economy, large exports, low corporate tax, low interest rates, investments in R&D activities, and low inflation. As their weightings are small, the significance of these factors can be questioned altogether. Respondents might have felt that they should give some points to all factors since they are included in the questionnaire instead of giving some factors zero points.

**Table 24. Weightings of the sub-factors**

<b>Sub-factor</b>	<b>Primary factor</b>	<b>Total*</b>	<b>Weightings in companies with FDI**</b>	<b>Weightings in companies with other modes of operation***</b>
Large number of customer companies	market pot.	13.7%	13.0%	15.1%
Large population	market pot.	10.1%	12.0%	6.5%
Close to Finland	infrastr.	6.5%	6.8%	6.0%
Little competition	market pot.	5.6%	4.8%	6.9%
Good transportation connections	infrastr.	5.3%	4.7%	6.4%
Low wages	cost adv.	5.2%	5.8%	4.0%
High level of education	resources	4.7%	4.7%	4.7%
Urbanization	market pot.	4.5%	4.5%	4.6%
Previous foreign investments	gen. econ.	4.2%	3.6%	5.3%
Low values of indicators of risk	risks	4.1%	4.1%	4.0%
High unemployment rate	resources	3.4%	3.7%	2.7%
High GRP/capita	market pot.	2.9%	3.2%	2.3%
Rich natural resources	resources	2.8%	2.6%	3.1%
Little corruption	risks	2.6%	1.8%	4.1%
Low additional costs of labor	cost adv.	2.5%	2.5%	2.5%
Low unit labor cost	cost adv.	2.4%	2.5%	2.2%
High level telecommunication infrastructure	infrastr.	2.4%	2.1%	3.1%
Stable public economy	gen. econ.	1.9%	1.3%	3.0%
Large exports	gen. econ.	1.8%	1.5%	2.4%
Low corporate tax	Cost adv.	1.6%	1.5%	1.8%
Low interest rates	risks	1.6%	1.3%	2.2%
Investments in R&D activities	resources	1.6%	1.4%	1.9%
Low inflation	gen. econ.	1.1%	0.9%	1.5%
<b>Total</b>		<b>92.5%</b>	<b>90.3%</b>	<b>96.3%</b>

\*n=59, \*\*n=39, \*\*\*n=20

The natural resources of a region weigh rather little (2.8%) in the scales of the investors. As Russia is known for its natural resources this result seems surprising. At the same time another resource factor, high level of education, counts for almost 5% of the decision criteria. Thus it seems that on the average Finnish companies are attracted rather by the educated work force than natural resources.

There are some differences in the ways companies with FDI and companies employing other modes of operation weight the factors. For example large population seems to be more important to FDI companies than to others. Low wages are unsurprisingly more important to companies with FDI, whereas absence of competition is more appreciated by other companies. Good transportation

connections get more consideration in companies not involved in FDI operations. The weightings of the sub-factors in different sectors are presented in Appendix 2.

The differences in the weightings of the factors between different types of companies are examined in a more detailed manner in the next chapter.

### **7.3 Background Variables' Influence**

In order to find out whether the different classification variables explain differences in the weightings of the location factors, mean values of the different types of companies need to be compared and analyzed. The Kolmogorov-Smirnov test was used to analyze the normality of the distribution of the location factors' weightings. As the weights given to the factors did not have normal distribution non-parametric tests had to be used. In this context the Mann-Whitney and Kruskal-Wallis tests were used.

The results of the analysis are presented in Appendix 3. Only statistically significant results are included in the appendix.

#### **7.3.1 Mode of Operation**

The first issue to be analyzed was whether the mode of operation (FDI or other) affects the evaluation of decision criteria. The Mann-Whitney test was used since in this case there are only two groups of data (FDI or other) that need to be compared. The results of the Mann-Whitney test are presented in Appendix 3.

The results show, that the operation mode affects only the weighting of the general economic factors at a statistically significant level when it comes to the primary factors. Companies with FDI do not pay as much attention to the general economic factors as other companies do. The mean values of the weightings of other primary factors do not differ significantly.

In the case of the so-called sub-factors a difference between companies with direct investments in Russia and other companies can be found in the weightings of large population, amount of corruption, previous FDI, and stable public economy. Companies that have chosen FDI as their business method set more weight on large population than other companies. The prevalence of corruption and stable public economy play a more important role in those companies' decision making that have not invested in Russia. The fact that the amount of previous foreign investments to the region is more important to those companies with no FDI in Russia is rather surprising.

As there is no intention in this context to study how the location factors are weighted in the case of other than FDI companies, from now on all results concern only the companies with foreign direct investments in Russia. The 20 remaining companies are excluded from the data set in the following analyses.

### **7.3.2 Line of Business**

Kruskal-Wallis test was used to study the differences in weightings of the factors in different sectors of economy. These results can be found in Appendix 3. Surprisingly it seems that the line of business of the respondent in Russia or overall has no statistically significant relation with the way the respondent weighs different location factors in his decision-making. The weightings of the seven primary factors are divided rather identically regardless of the companies' lines of business. When it comes to the sub-factors the situation is rather similar. Developed ICT-sector is the only sub-factor with statistically differing weightings between different sectors. The service and retail sectors put more weight on the level of ICT than the manufacturing and construction sectors.

### **7.3.3 Company Size**

The results of the Kruskal-Wallis test concerning the effects of company size on the weightings of the location factors are presented in Appendix 3. In the case of the seven principal factors it seems that large companies (over 5,000 employees overall and turnover larger than 10,000 euros in Russia) tend to put more weight on the market potential, whereas smaller companies appreciate lower costs and the availability of resources. When it comes to the cost factor the difference between small and large companies is statistically significant both when the turnover and the number of employees is used as a measure.

In the case of the sub-factors' weightings differences between different sized companies can be found in the weighting of large population, labor costs, level of education, R&D expenditure, natural resources, and unemployment rate. Companies with large overall turnover (200,000,000 EUR or more) consider large population to be a more important factor than other companies do. On the other hand large companies (overall turnover 200,000,000 EUR or more and more than 5,000 employees) do not pay as much attention to labor costs or education level of the population as smaller companies. Medium-sized companies (50 to 4,999 employees, or turnover of 500 to 99,999 thousand in Russia) put more weight on high unemployment rate than smaller and larger companies do. Companies with overall turnover between 2,000 and 199,999 thousand euros also appreciate large R&D expenditure and natural resources more than others.

### **7.3.4 Motives**

The effects of the companies' primary motives for operating in Russia on the weighting of the location factors are somewhat difficult to measure, since the distribution of the answers between different motives is extremely uneven. The results of the Kruskal-Wallis test are presented in Appendix 3, but they should be interpreted with caution. The weight of the market potential and its sub-factors is naturally larger in the group consisting of market-seeking investors while

resource-, and efficiency-seeking investors appreciate high unemployment rate and low labor costs. Especially the strategic asset-seeking investors consider the level of transportation infrastructure in their decision-making.

### **7.3.5 Location**

As most of the respondent companies operate in either Moscow or St. Petersburg, the analysis of the influence of the company's location on the weighting of the location factors is not too reliable. The results (Appendix 3) however show, that companies operating in Northwest FD appreciate the availability of natural resources and labor force more than others.

### **7.3.6 Time**

In order to study the differences in the weightings of the factors over time, the data was divided into three groups based on the year that the latest investment in Russia (at the same time the one that their response is based on) has been made. Some foreseeable yet important results were discovered. For example the significance of the Russian region's proximity to Finland was larger in the beginning of the 1990s than it was in the late 1990s or has been in the beginning of the 21<sup>st</sup> century. The amount of corruption has also lost some of its significance as a decision-making criterion in the latter half of the 1990s and the past four years.

## **7.4 Ranking of the Russian Regions**

One of the objectives of this study was to rank the Russian regions from the Finnish companies' perspective. The ranking can be done with the help of proxies for each location factor and the average weightings of the factors. The values for each of the estimators (presented in Chapter 6.1 and Table 13) in each of the

Russian regions were obtained from Goskomstat (2003), Expert.ru (2004), and Central Bank of Russia (2004).

In order to rank the Russian regions from the point of view of a foreign investor, all of the indicator values for each region were first converted into relative figures. The best indicator value corresponds to 100 points, and other regions were proportioned to the number one region<sup>5</sup>. Thus each region got a score between 0 and 100 for each of the indicators. These scores were then multiplied by the average weighting of the specific factor among the respondents. A final score of attractiveness was then calculated by summing up the regions' scores for each of the indicators.

As not all of the indicators were available for the so-called sub-regions, they were not treated separately in the ranking process. Instead these regions were included in the larger regions parts of which they are.

The ranking of the regions was calculated for each branch of business separately, as the value of competition indicator differs from sector to sector. The top ten regions from the point of view of four branches are presented in Table 26. Next to each region there is the final score of the region proportioned to the number one region, whose relative score is 100. More extensive rankings (top-20) are presented in Appendix 4.

Expectedly Moscow city is the number one region from Finnish companies' perspective. St. Petersburg city and Moscow oblast occupy the second and third positions after Moscow city. Krasnodar krai is the fourth most attractive region in the retail, service and construction sectors, from the manufacturing sector's point of view it is number eight in the ranking. Leningrad oblast, which surrounds the

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<sup>5</sup> For example as Moscow City has most customer companies, it gets 100 points for that specific factor. Other regions' populations are proportioned against Moscow's population. For example St. Petersburg's score can be calculated as follows: customer companies in St. Petersburg / customer companies in Moscow \* 100 = 275,381/909,522\*100 = 30.3.

city of St. Petersburg is another attractive investment location based on the Finnish companies' criteria. It ranks fifth in retail, service and construction sectors, but surprisingly does not make the top ten in manufacturing. Republic of Tatarstan, Sverdlovsk oblast and Rostov oblast all place themselves among the top ten regions no matter what the sector. Samara oblast and Nizhnii Novgorod oblast seem to suit the criteria of manufacturing, service and construction sectors, while the Republic of Bashkortostan makes the top ten in manufacturing and retail sectors. The high ranking of the Republic of Dagestan in the retail sector might be somewhat misleading, as the region is the neighbor of the Chechen republic, and its risk rating is one of the highest in Russia. The number of companies in the region is low, and thus the competition is almost non-existent, which increases the region's attractiveness.

**Table 25. Ranking of the Russian regions**

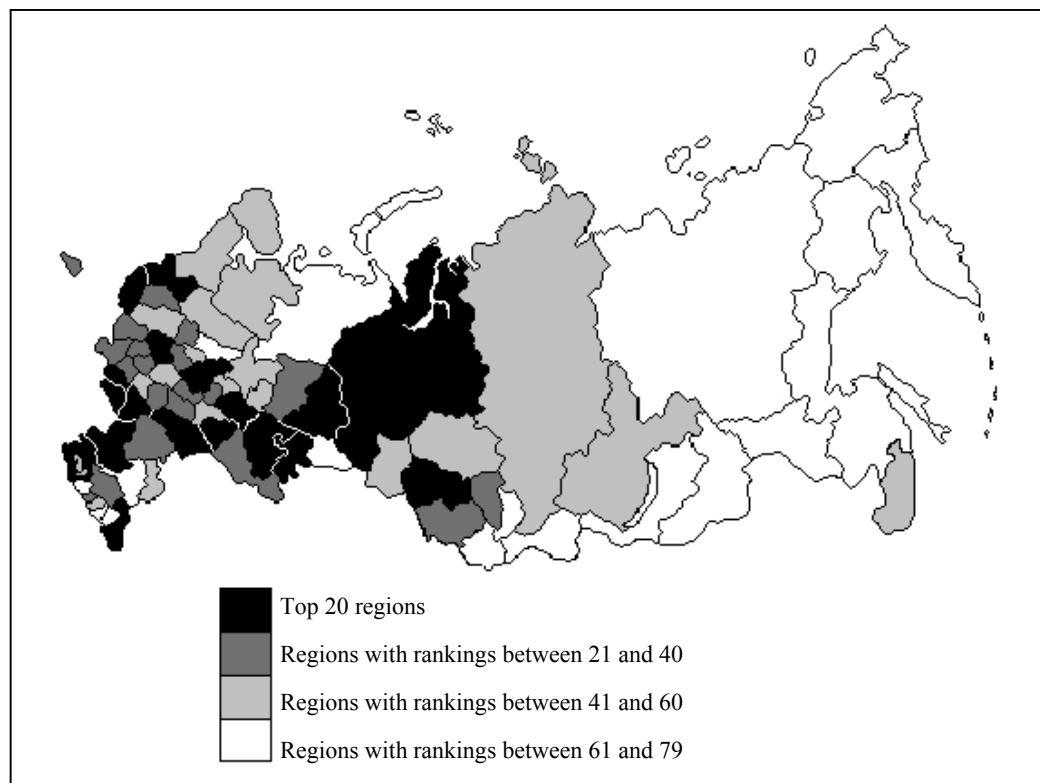
<b>Manufacturing</b>		<b>Retail</b>		<b>Services</b>		<b>Construction</b>	
1. Moscow city	100	1. Moscow city	100	1. Moscow city	100	1. Moscow city	100
2. St. Petersburg	71	2. Moscow obl.	73	2. St. Petersburg	67	2. St. Petersburg	63
3. Moscow obl.	70	3. St. Petersburg	70	3. Moscow obl.	58	3. Moscow obl.	57
4. Tatarstan Rep.	63	4. Krasnodar krai	62	4. Krasnodar krai	49	4. Krasnodar krai	47
5. Nizhnii Novgorod obl.	62	5. Leningrad obl.	61	5. Leningrad obl.	49	5. Leningrad obl.	46
6. Sverdlovsk obl.	60	6. Tatarstan Rep.	61	6. Rostov obl.	49	6. Sverdlovsk obl.	45
7. Bashkortostan Rep.	60	7. Rostov obl.	61	7. Tatarstan Rep.	48	7. Nizhnii Novgorod obl.	44
8. Krasnodar krai	60	8. Dagestan Rep.	60	8. Samara obl.	48	8. Rostov obl.	44
9. Rostov obl.	59	9. Sverdlovsk obl.	60	9. Nizhnii Novgorod obl.	48	9. Samara obl.	44
10. Samara obl.	58	10. Bashkortostan Rep.	59	10. Sverdlovsk obl.	47	10. Tatarstan Rep.	43

The common denominator between most of the regions in the top ten is the presence of a city with over 1 million inhabitants. Rostov oblast, Krasnodar krai and the republic of Dagestan are the only regions where the largest city has less than 1 million inhabitants. However as the center of the Rostov oblast, Rostov-na-Donu, has over 990 000 inhabitants, and the Dagestan Republic is a so-called black horse, the Krasnodar krai is the only important region appearing in the top ten listing without a larger city in its territory.

The attractiveness of the regions with large cities in their territory is no surprise, as most of the respondents considered themselves market-seeking investors. The results might be somewhat different, if there had been more resource-seeking investors among the respondents. If that had been the case some of the vast Far-Eastern and Siberian regions would most likely have made it to the top 10.

The sensitivity of the ranking presented above was tested by excluding the most insignificant factors, those that weigh less than 2%, from the calculations. The composition of the top ten most attractive regions did not change notably.

The geographical distribution of the most attractive regions in the light of the survey answers is presented in Figure 15. The sectoral perspective is eliminated in this context, as the map is based on the average scores of the regions in different sectors. The Russian regions are colored according to their ranking position. The darker the region the more attractive it is to the foreign investor.



**Figure 15. Average rankings of the Russian regions**

It is no surprise, that practically all of the top 20 regions are located west of the Urals. Primorskii Krai is the only region in the Far East Federal District ranked among 60 most attractive companies. Novosibirsk oblast seems to be the only exception to this rule: it is located in the Siberian Federal District and yet it makes it to the top 20.

What should be noted is the fact that the most attractive regions are rather evenly dispersed west of the Urals. Central, Northwest, Southern, Volga and Urals Federal Districts all include highly ranked regions. Investors should thus be looking beyond St. Petersburg and Moscow.

## **7.5 Looking beyond the Two Capitals**

As the Goskomstat data shows that Finnish companies have been very attracted to Moscow and St. Petersburg (see p. 56), it seems appropriate to state that Finnish companies are operating in those regions, which fit their criteria. However there are plenty of other regions in the top-10 ranking as well, and they should probably be given serious consideration as well.

For example Krasnodar Krai ranks higher than Leningrad oblast in all four rankings. Krasnodar Krai is located in the Southern FD, in which only 9 Finnish companies had subsidiaries in 2002. In the Volga FD there are also several regions that appear to be attractive in the light of the Finnish companies' criteria. These regions include such metropolitans as Nizhnii Novgorod and Samara Oblasts as well as the Republic of Bashkortostan, which is endowed with abundant natural resources. Yet only 15 Finnish companies had subsidiaries in the Volga FD in 2002.

As Finnish companies seem to appreciate the geographical proximity of the target region, Central and North-West Federal Districts seem to be the obvious choices.

However as the significance of the region's proximity to Finland is decreasing, it could be expected that companies are increasingly willing to look beyond Moscow and St. Petersburg.

## 8 CONCLUSIONS

This chapter aims to give a concise answer to the research questions presented in the beginning of this thesis. The main task of this study was to find out which factors Finnish companies take into consideration when they are selecting a location for their investment inside Russia. The sub-questions dealt with such issues as whether different companies appreciate different attributes, which are the Russian regions that Finnish companies should invest in, and whether Finnish companies indeed have chosen regions that fit their criteria. The 12 most important findings of this study are presented in the following (in bold), and the research questions reviewed above are used as a framework. At the end of this chapter some suggestions for further research are made.

### 8.1 Location Factors of Finnish FDI in Russia

**It seems that the number one factor attracting the Finnish companies that participated in this study, regardless of their line of business, size, or mode of operation, to a certain Russian region is the market potential of a candidate region.** Market potential forms 36% of the basis for the location decision, and in the case of companies with FDI in Russia the share is even higher, 38%. Other factors that each count for over one tenth of the decision criteria in the FDI companies include infrastructure (13%), costs (13%), and resources (13%). These results are not surprising in the light of previous research, which also highlights the effects of these factors on the investment location.

**Finnish investors are not necessarily attracted by natural resources.** The overwhelming dominance of market potential as a location criterion is a slight surprise, as transitional countries are often considered a source of cheap labor force and natural resources. Even though several large, western companies have become extremely interested in the Russian mineral base, it seems that Finnish companies are more drawn to urban regions with plenty of market potential.

The large weighting of the market potential seems natural, as most respondents mentioned markets as their primary motive for operating in Russia. In the future it would be interesting to study the resource-seeking Finnish companies operating in Russia (for example forest companies), and compare their location criteria to those of the market-seeking companies.

**Market potential, infrastructure, costs, resources, risks, and general economic factors form 92% of the criteria that the location decision is based on.** As the average weighting of “other factors” was merely 8% among the FDI companies, it can be concluded that the six primary factors included in the questionnaire quite comprehensively capture the essence of the location decision criteria. None of the primary factors received an average weighting smaller than 8%, which implies that all of them are to some extent considered in the decision-making.

**Proximity to Finland is the third most important attribute of a region in the eyes of Finnish investors.** It is somewhat surprising that geographical proximity is so highly appreciated by the Finnish investors, as modern technologies and other solutions shorten geographical distances. **On the other hand the importance of Finland’s proximity has been decreasing in recent years.** Thus it seems that Finnish investors are becoming more willing to look beyond the North-West Russia while scanning for location alternatives.

**The selection of the 23 sub-factors was not quite as successful as the selection of the primary factors.** Six factors weigh less than 1.5% in the location decision, and the combined weight of the ten most insignificant sub-factors in less than 17%. At the same time five most important sub-factors combined add up to 40% of the decision criteria.

As it is rather difficult to pin down all the regional attributes that affect the location decision, and at the same time a handful of factors rises above others in

significance, it would seem justified to concentrate on identifying that handful of the most influential factors. In further studies it would be interesting to try to find other factors not included in this study, that affect the location decision as strongly as the top-ten factors identified here.

## **8.2 The Influence of Company Characteristics**

The differences in the weightings of the location factors between different types of companies were surprisingly small.

**The results imply that FDI companies and companies with other modes of operation appreciate same things in a potential FDI location.** REM model gives reason to assume that companies employing different modes of international business would appreciate different regional attributes while considering a location for their investment. Yet the only primary factor with significantly different weightings between companies with and without FDI was *General economic factors*. Of the 23 sub-factors only four received weightings that differed between companies with and without FDI at a statistically significant level.

**It seems that Finnish investors operating in different sectors of the economy consider the same factors when selecting a location for their investment in Russia.** There are no statistically significant differences in the weightings of the primary factors between companies operating in different sectors.

The differences in the location decision process in different sized investor companies have not been addressed in previous research. **This study however shows that there are some differences in the decision-making criteria between small and large companies.** The larger the company the more market oriented it tends to be, while smaller companies appreciate lower costs and the availability of resources. It is rather natural that large companies are after large markets, as they

aim to take advantage of the economies of scale. On the other hand large companies are not too dependent on local resources, as they probably have the capability to import or create the necessary resources themselves. Naturally this is not the case when it comes to natural resources.

### **8.3 Most Attractive Regions for Finnish Investors**

In the light of the survey results, it is rather obvious that **Moscow and St. Petersburg are the most attractive destinations for Finnish investors in Russia, yet a number of other regions meet the Finnish criteria as well.** Other attractive regions are also mainly located west of the Urals. This is no surprise, as the Finnish companies are after large markets. Regions east of Urals are sparsely inhabited and large cities are far apart and thus not too attractive in the eyes of Finnish investors. The top-ten most attractive regions typically surround cities with over one million inhabitants.

As Moscow and St. Petersburg have been the most popular targets among Finnish investors, it seems that Finnish companies have indeed chosen the regions that correspond to their criteria. However there are several other Russian regions that score relatively well in the attractiveness ranking, especially if compared to St. Petersburg, yet the Finnish companies are still mainly operating in the two Russian capitals. **Thus it seems, that as there are other regions in Russia that meet the criteria of the Finnish investors, the investors should start looking beyond Moscow and St. Petersburg.**

**All in all the Finnish investor's location decision in Russia is generally based on the same criteria that have been identified in studies focused on other countries.** The three most important factors, market potential, adequate infrastructure, and cost benefits attract Finnish companies in Russia as well. The cost benefits' significance was however surprisingly small.

As FDI is becoming an increasingly popular mode of operating abroad, it will remain an important subject for research. The research on locational determinants of FDI inside a country is still in its infancy. Up till now research has mainly been based on secondary data, and the quantifying of the issue has created a rather one-sided perspective. In addition most of the research has concentrated on western, developed countries. This study has been an attempt to approach the issue from the company perspective instead of the statistical perspective. In addition this study has for the first time applied the location factor theories to Russia.

#### **8.4 Recommendations for Further Research**

In future research it would be extremely interesting to find a way to study the company-specific, internal location factors alongside the external ones. This study has considered only a very limited number of company-specific factors, and in addition they have only been used as variables explaining differences in the weightings of the location-specific variables.

As most of the respondents in this study mentioned markets as their number one motive for operating in Russia, the differences in the factor weightings between companies with different motives could not be studied in depth. Further studies should aim to fill this gap.

More appropriate proxies for the different factors should also be created in future studies. Some of the proxies used in this study are somewhat artificial, and some of them are not necessarily the best estimators for the location factors. Some of the location factors had to be excluded from the study since appropriate proxies were not found. A suitable proxy should be created for example for investment incentives, so that they could be included in further studies.

Another interesting research question for further studies is whether the nature of the investment influences the location criteria. It might very well be, that

greenfield investors appreciate different attributes than those investors that penetrate the market through acquisition.

Most foreign companies have operated in the Russian market for only little over ten years. As mentioned above, some changes in the FDI location criteria have already taken place. However in future studies the changes can be studied more comprehensively as the time perspective gets longer.

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11/19/04



## Ulkomaisen investoinnin sijaintiin vaikuttavat tekijät Venäjällä – Kysely yrityksille

### Tutkimuksen tarkoitus

Teen Lappeenrannan teknillisen yliopiston yhteydessä toimivassa Pohjoisen ulottuvuuden tutkimuskeskuksessa tutkimusta koskien yritysten liiketoimintaa Venäjällä. Tutkimuksessa pyritään selvittämään niitä tekijöitä, jotka vaikuttavat suoran ulkomaisen investoinnin sijaintiin Venäjällä. Työn ohjaajana toimii professori Tauno Tiusanen.

Kysely on suunnattu Suomalais-Venäläisen Kauppakamarin jäsenyrityksille, ja se tehdään yhteistyössä kauppakamarin kanssa. Yritysten yhteystiedot on saatu SVKK:n jäsenrekisteristä.

Tutkimuksessa keskitytään arvioimaan yrityksen **ulkopuolisten tekijöiden** vaikutusta yrityksen liiketoiminnan sijaintipaikan valintaan. Yrityksen sisäiset tekijät (esim. suhteet ja henkilöstön osaaminen) jätetään tutkimuksen ulkopuolelle. **Kysymyslomakkeessa Teitä pyydetään arvioimaan, minkälainen painoarvo eri tekijöillä on, kun yrityksessänne päätetään liiketoimintanne tarkemmasta sijainnista Venäjän sisällä.** Vastauksien perusteella Venäjän alueet pyritään asettamaan paremmuusjärjestykseen ulkomaisen investoijan kannalta.

### Kysymyslomakkeen sisältö ja ohjeistus

Kysymyslomake koostuu kahdesta osasta:

1. osassa Teitä pyydetään arvioimaan eri tekijöiden merkitystä yrityksenne päätöksenteossa, ja
2. osassa kysytään yrityksen taustatietoja.

Teitä pyydetään arvioimaan sekä seitsemän päätekijän välisiä painoarvoja että kunkin päätekijän alle listattujen alatekijöiden keskinäisiä painoarvoja jakamalla 100 pistettä eri tekijöiden kesken. Vastaaminen vie aikaa noin 15 minuuttia. Toivon, että palautatte täytetyn lomakkeen oheisessa palautuskuoressa **torstaihin 19.8.2004 mennessä** (postimaksu maksettu).

Kaikki vastaukset käsitellään ehdottoman luottamuksellisesti. Yksittäiset vastaukset tulevat tutkimuksessa esille ainoastaan tilastoyksikköinä.

Kiitokseksi vaivannäöstänne tarjoan Teille mahdollisuuden saada käyttöönnne tiivistelmän tutkimuksen keskeisistä tuloksista. Mikäli olette kiinnostuneita tiivistelmästä, pyydän Teitä täyttämään sähköpostiosoitteenne kyselyn loppuun.

Vastaan mielelläni kaikkiin tutkimusta koskeviin kysymyksiin!

Venla Laakkonen

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1. Arvioika seuraavien tekijöiden merkitystä valitessanne viimeiseksi aloitetun tai vaihtoehtoisesti suunnitteilla olevan liiketoiminnan kohdealuetta Venäjällä. Toisin sanoen mikäli yrityksellänne on tytäryritys Pietarissa, pyrkikää vastaamaan kysymykseen "Miksi toimitte juuri Pietarissa?".

Tekijät on jaettu seitsemään pääluokkaan, joiden kesken voitte jakaa 100 pistettä sen mukaan, kuinka tärkeä kukin tekijä on. Mitä tärkeämpi tekijä on, sitä korkeammat pisteet sille voi antaa. Lisäksi kukin pääluokka sisältää useita alatekijöitä, joiden kesken voitte kunkin pääluokan sisällä jakaa 100 pistettä niin ikään sen mukaan, kuinka tärkeitä alatekijät ovat pääluokan sisällä.

Esimerkivastaus:

	Painoarvo		painoarvo
Infrastruktuuri	20	▪ Tietoliikennetekniikan korkea taso	30
		▪ Hyvät liikenneyhteydet	20
		▪ Alue lähellä Suomea	50
			=100

Mikäli vastaatte kysymykseen viimeiseksi aloitetun liiketoiminnan perusteella, kertokaa, minä vuonna kyseinen toiminta on aloitettu: \_\_\_\_\_

	Painoarvo		painoarvo
Markkina-potentiaali		▪ Korkea BKT/asukas	
		▪ Suuri väkiluku	
		▪ Vähän kilpailua	
		▪ Pajon asiakasyrityksiä	
		▪ Kaupungistuneisuus ja korkea väestötiheys	
			=100
Infrastruktuuri		▪ Tietoliikennetekniikan korkea taso	
		▪ Hyvät liikenneyhteydet	
		▪ Alue lähellä Suomea	
			=100
Kustannukset		▪ Alhainen yritysvero	
		▪ Matala palkkataso	
		▪ Alhaiset työn sivukustannukset	
		▪ Alhaiset työn yksikkökustannukset	
			=100
Resurssit		▪ Korkea koulutustaso	
		▪ Korkea työttömyysaste (työvoiman saatavuus)	
		▪ Runsaat luonnonvarat	
		▪ Suuret tutkimus- ja kehitystyöhön kohdennetut varat	
			=100
Riskit		▪ Yleisten riskitason mittarien alhaiset arvot	
		▪ Korruption vähäisyys	
		▪ Alhainen korkotaso	
			=100
Yleiset taloudelliset tekijät		▪ Alueelle aiemmin tehdyt ulkomaiset investoinnit	
		▪ Matala inflaatio	
		▪ Runsas vienti alueelta	
		▪ Vakaa julkinen talous	
			=100
Muut tekijät		Mainitse kolme tärkeintä (näitä tekijöitä ei ole tarpeen painottaa keskenään):	
	=100		

<p>2. Yrityksenne pääasiallinen toimiala:</p> <p>a) Koko yritys/konserni _____</p> <p>b) Venäjällä _____</p>	<p>3. Kuinka monta työntekijää yrityksessänne on?</p> <p>c) Yhteensä _____</p> <p>d) Venäjällä _____</p>
<p>4. Mikä oli yrityksenne liikevaihto vuonna 2003?</p> <p>a) Yhteensä _____ EUR</p> <p>b) Venäjällä _____ EUR</p>	<p>5. Mikä oli / on <b>keskeisin syy</b> toiminnan aloittamiseen Venäjällä?</p> <p><input type="checkbox"/> Uudet markkinat</p> <p><input type="checkbox"/> Tuotannon tekijämarkkinat</p> <p><input type="checkbox"/> Kustannusedut</p> <p><input type="checkbox"/> Muut strategiset syyt</p> <p><input type="checkbox"/> Muu syy, mikä? _____</p>
<p>6. Minkälaista toimintaa yrityksellänne on Venäjällä? Missä päin Venäjää kyseistä toimintaa on?</p> <p><input type="checkbox"/> Täysin omistettu tytäryritys Sijainti ja perustamisvuosi: _____</p> <p><input type="checkbox"/> Yhteisyritys Sijainti ja perustamisvuosi: _____</p> <p><input type="checkbox"/> Edustusto Sijainti ja perustamisvuosi: _____</p> <p><input type="checkbox"/> Agentti Sijainti ja perustamisvuosi: _____</p> <p><input type="checkbox"/> Muu, mikä? _____ Sijainti ja perustamisvuosi: _____</p> <p><input type="checkbox"/> Ei toimintaa Venäjällä</p>	
<p>7. Miten aiotte kehittää toimintaanne Venäjällä seuraavan viiden vuoden aikana?</p> <p><input type="checkbox"/> Lisätä sitä</p> <p><input type="checkbox"/> Aloittaa toiminta</p> <p><input type="checkbox"/> Vähentää toimintaa</p> <p><input type="checkbox"/> Lopettaa toiminta</p> <p><input type="checkbox"/> Pitää toiminta ennallaan</p>	

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Olkaa hyvä ja täyttäkää tähän yhteystietonne, mikäli haluatte tiivistelmän tutkimuksen keskeisistä tuloksista.

Sähköpostiosoite: \_\_\_\_\_

KIITOS VASTAUKSESTANNE!

	<b>Manufacturing</b>	<b>Retail</b>	<b>Service</b>	<b>Construction</b>
High GDP/capita	2.77%	2.81%	1.56%	4.95%
Large population	13.46%	11.61%	6.88%	13.39%
Little competition	6.89%	5.72%	2.38%	1.89%
Large number of customer companies	10.08%	11.00%	15.13%	16.94%
Urbanization	4.20%	5.39%	2.81%	4.05%
High level telecommunication infrastructure	0.81%	1.81%	4.44%	1.60%
Good transportation connections	3.73%	5.19%	5.88%	4.33%
Close to Finland	5.81%	6.75%	6.56%	8.33%
Low corporate tax	1.52%	1.78%	1.69%	1.05%
Low wages	8.60%	6.39%	3.47%	3.33%
Low unit labor cost	2.16%	2.33%	2.78%	3.17%
High level of education	4.16%	3.06%	7.46%	4.28%
High unemployment rate	2.71%	3.50%	5.90%	3.06%
Rich natural resources	2.48%	4.00%	1.46%	1.80%
Large investments in R&D activities	1.70%	1.06%	0.68%	1.60%
Low values of indicators of risk	4.73%	3.75%	4.51%	2.42%
Low interest rates	1.27%	0.89%	1.11%	1.58%
Previous foreign investments	3.54%	1.86%	1.69%	6.78%
Low inflation	0.50%	0.81%	0.64%	1.25%
Large exports	1.25%	2.07%	1.40%	1.39%
Stable public economy	0.92%	0.86%	0.77%	2.30%
<b>Total</b>	<b>90.18%</b>	<b>88.36%</b>	<b>81.58%</b>	<b>91.38%</b>

**Mann-Whitney test – Grouping variable: mode of operation**

	Mode of operation	N	Mean Rank	Sum of Ranks
General economic factors	Other	20	36.45	729.00
	FDI	39	26.69	1041.00
	Total	59		
Large population	Other	20	23.43	468.50
	FDI	38	32.70	1242.50
	Total	58		
Little corruption	Other	20	36.50	730.00
	FDI	36	26.28	866.00
	Total	56		
Previous FDI	Other	20	35.30	706.00
	FDI	36	24.72	890.00
	Total	56		
Stable public economy	Other	20	36.78	735.50
	FDI	36	23.90	860.50
	Total	56		

	General economic factors	Large population	Little corruption	Previous FDI	Stable public economy
Mann-Whitney U	261.000	258.500	200.000	224.000	194.500
Wilcoxon W	1041.000	468.500	866.000	890.000	860.500
Z	-2.158	-1.997	-2.804	-2.353	-2.926
Asymp. Sig. (2-tailed)	0.031	0.046	0.005	0.019	0.003

**Kruskal-Wallis test – Grouping variable: line of business**

	Line of business	N	Mean Rank
High level of telecomm. infrastructure	Manufacturing	15	14.93
	Retail	8	26.56
	Service	6	21.17
	Construction	8	17.44
	Total	37	

	High level of telecomm. infrastructure
Chi-Square	6.840
Degrees of freedom	3
Asymp. Sig. (2-tailed)	0.077

**Kruskal-Wallis test – Grouping variable: line of business in Russia**

	Line of business in Russia	N	Mean Rank
High level of telecomm. infrastructure	Manufacturing	12	14.13
	Retail	8	26.56
	Service	8	19.75
	Construction	9	18.11
	Total	37	

	High level of telecomm. infrastructure
Chi-Square	8.850
Degrees of freedom	3
Asymp. Sig. (2-tailed)	0.077

**Kruskal-Wallis test – Grouping variable: overall turnover**

	Overall turnover (1000 EUR)	N	Mean Rank
Costs	<1,999	2	31.25
	2,000-9,999	8	16.13
	10,000-39,999	8	27.38
	40,000-199,999	9	17.72
	<200,000	9	10.67
Large population	<1,999	2	17.75
	2,000-9,999	8	12.50
	10,000-39,999	8	17.19
	40,000-199,999	9	16.39
	<200,000	9	27.28
Low wages	<1,999	2	26.50
	2,000-9,999	8	17.13
	10,000-39,999	8	26.13
	40,000-199,999	9	17.17
	<200,000	9	12.50
Low unit labour costs	<1,999	2	34.00
	2,000-9,999	8	17.00
	10,000-39,999	8	19.81
	40,000-199,999	9	23.06
	<200,000	9	10.67
High level of education	<1,999	2	17.75
	2,000-9,999	7	22.50
	10,000-39,999	8	18.69
	40,000-199,999	8	22.17
	<200,000	9	9.78
Large R&D expenditure	<1,999	2	9.00
	2,000-9,999	7	21.14
	10,000-39,999	8	17.06
	40,000-199,999	9	24.67
	<200,000	9	11.72

	Costs	Large population	Low wages	Low unit labour cost	High level of education	Large R&D expenditure
Chi-Square	14.48	8.468	8.620	11.566	8.915	10.710
Degrees of freedom	4	4	4	4	4	4
Asymp. Sig. (2-tailed)	0.006	0.076	0.071	0.021	0.063	0.030

**Kruskal-Wallis test – Grouping variable: overall number of employees**

	Overall number of employees	N	Mean Rank
Market potential	0-49	7	17.14
	50-99	6	19.58
	100-499	10	19.75
	500-4999	9	13.78
	5000-	6	30.33
Costs	0-49	7	19.07
	50-99	6	26.08
	100-499	10	21.80
	500-4999	9	20.33
	5000-	6	8.33
Low wages	0-49	7	18.00
	50-99	6	21.00
	100-499	10	22.90
	500-4999	9	23.06
	5000-	6	8.75
High level of education	0-49	7	28.75
	50-99	6	17.92
	100-499	10	18.25
	500-4999	9	20.78
	5000-	6	8.92
High unemployment rate	0-49	6	12.25
	50-99	6	24.33
	100-499	10	23.00
	500-4999	9	21.89
	5000-	6	9.42
Abundant natural resources	0-49	6	15.58
	50-99	6	22.83
	100-499	10	16.30
	500-4999	9	26.17
	5000-	6	12.33

	Market potential	Costs	Low wages	High level of education	High unempl. rate	Abundant natural resources
Chi-Square	8.526	9.005	7.773	10.627	11.006	8.793
Degrees of freedom	4	4	4	4	4	4
Asymp. Sig. (2-tailed)	0.074	0.061	0.100	0.031	0.026	0.066

**Kruskal-Wallis test – Grouping variable: turnover in Russia**

	Turnover in Russia	N	Mean Rank
Market potential	0-499	7	17.07
	500-999	4	6.75
	1000-9999	10	16.65
	10000-	12	20.67
High unemployment rate	0-499	7	15.50
	500-999	3	29.17
	1000-9999	10	19.30
	10000-	12	11.58

	Market potential	High unemployment rate
Chi-Square	6.311	10.317
Degrees of freedom	3	3
Asymp. Sig. (2-tailed)	0.097	0.016

### Kruskal-Wallis test – Grouping variable: Primary motive for operating in Russia

	Primary motive	N	Mean Rank
Market potential	Markets	31	22.42
	Resources	1	27.50
	Efficiency	3	3.83
	Strategic assets	4	11.50
	Other	0	
Large population	Markets	31	22.17
	Resources	1	9.00
	Efficiency	3	3.00
	Strategic assets	4	14.50
	Other	0	
High level of transportation infrastructure	Markets	31	17.53
	Resources	1	12.00
	Efficiency	3	19.17
	Strategic assets	4	31.25
	Other	0	
Low additional labour costs	Markets	31	18.69
	Resources	1	29.00
	Efficiency	3	34.83
	Strategic assets	4	16.75
	Other	0	
High unemployment rate	Markets	31	17.35
	Resources	1	25.50
	Efficiency	3	37.00
	Strategic assets	4	21.00
	Other	0	
Large exports	Markets	28	16.25
	Resources	1	32.50
	Efficiency	3	21.00
	Strategic assets	4	28.88
	Other		

	Market pot.	Large population	High level of transportation infrastructure	Low additional labour costs	High unempl. rate	Large exports
Chi-Square	10.216	10.102	6.265	6.548	9.322	7.790
Degrees of freedom	3	3	3	3	3	3
Asymp. Sig. (2-tailed)	0.017	0.018	0.099	0.088	0.025	0.051

**Kruskal-Wallis test – Grouping variable: Location of the investment**

	Location of the investment	N	Mean Rank
Resources	St. Petersburg	18	14.56
	Moscow city	12	19.79
	North-West FD (exl. SPb)	3	33.33
	Other	3	22.17
High unemployment rate	St. Petersburg	18	15.25
	Moscow city	11	19.55
	North-West FD (exl. SPb)	3	33.67
	Other	3	13.17

	Resources	High unemployment rate
Chi-Square	9.435	9.637
Degrees of freedom	3	3
Asymp. Sig. (2-tailed)	0.024	0.022

**Kruskal-Wallis test – Grouping variable: The year the FDI was made**

	The year the FDI was made	N	Mean Rank
Proximity to Finland	1991-1995	8	19.81
	1996-2000	5	11.70
	2001-	15	12.60
Little corruption	1991-1995	8	19.06
	1996-2000	4	8.00
	2001-	16	13.84

	Proximity to Finland	Little corruption
Chi-Square	4.749	5.990
Degrees of freedom	2	2
Asymp. Sig. (2-tailed)	0.093	0.050

## Ranking of the Russian regions in the light of the survey results

### Manufacturing companies

Rank	Region	Score	Relative score
1	Moscow city	5428	100,0
2	SPB	3861	71,1
3	Moscow oblast	3772	69,5
4	Tatarstan Rep.	3440	63,4
5	Nizhnii Novgorod oblast	3368	62,0
6	Sverdlovsk oblast	3263	60,1
7	Bashkortostan Rep.	3260	60,1
8	Krasnodar krai	3248	59,8
9	Rostov oblast	3222	59,3
10	Samara oblast	3133	57,7
11	Voronezh oblast	3069	56,5
12	Kemerovo oblast	3050	56,2
13	Chuvash Rep.	3023	55,7
14	Belgorod oblast	3002	55,3
15	Saratov oblast	2994	55,2
16	Kursk oblast	2978	54,9
17	Chelyabinsk oblast	2961	54,6
18	Perm oblast	2940	54,2
19	Leningrad oblast	2918	53,7
20	Novosibirsk oblast	2906	53,5

### Retail companies

Rank	Region	Score	Relative Score
1	Moscow city	5044	100
2	Moscow oblast	3659	73
3	SPB	3538	70
4	Krasnodar krai	3109	62
5	Leningrad oblast	3091	61
6	Tatarstan Rep.	3082	61
7	Rostov oblast	3072	61
8	Dagestan Rep.	3013	60
9	Sverdlovsk oblast	3005	60
10	Bashkortostan Rep.	2997	59
11	Nizhnii Novgorod oblast	2984	59
12	Saratov oblast	2943	58
13	Belgorod oblast	2917	58
14	Samara oblast	2853	57
15	Perm oblast	2850	57
16	Kursk oblast	2841	56
17	Kabardino-Balkar Rep.	2841	56
18	Chelyabinsk oblast	2829	56

19	Voronezh oblast	2814	56
20	Pskov oblast	2812	56

### Service Companies

Rank	Region	Score	Relative Score
1	Moscow city	5270	100
2	SPB	3523	67
3	Moscow oblast	3029	57
4	Krasnodar krai	2588	49
5	Leningrad oblast	2568	49
6	Rostov oblast	2560	49
7	Samara oblast	2521	48
8	Tatarstan Rep.	2520	48
9	Nizhnii Novgorod oblast	2517	48
10	Sverdlovsk oblast	2459	47
11	Novosibirsk oblast	2435	46
12	Voronezh oblast	2421	46
13	Kaliningrad oblast	2396	45
14	Pskov oblast	2374	45
15	Bashkortostan Rep.	2347	45
16	Belgorod oblast	2341	44
17	Saratov oblast	2334	44
18	Novgorod oblast	2300	44
19	Dagestan Rep.	2284	43
20	Kursk oblast	2268	43

### Construction companies

Rank	Region	Score	Relative Score
1	Moscow city	6383	100,0
2	SPB	4016	62,9
3	Moscow oblast	3656	57,3
4	Krasnodar krai	2996	46,9
5	Leningrad oblast	2962	46,4
6	Sverdlovsk oblast	2857	44,8
7	Nizhnii Novgorod oblast	2828	44,3
8	Rostov oblast	2805	43,9
9	Samara oblast	2777	43,5
10	Tatarstan Rep.	2758	43,2
11	Chelyabinsk oblast	2603	40,8
12	Bashkortostan Rep.	2601	40,8
13	Novosibirsk oblast	2595	40,7
14	Voronezh oblast	2532	39,7
15	Saratov oblast	2527	39,6
16	Pskov oblast	2527	39,6

17	Kaliningrad oblast	2467	38,6
18	Tyumen oblast	2441	38,2
19	Novgorod oblast	2436	38,2
20	Perm oblast	2434	38,1

### Average ranking

Rank	Region	Score	Relative Score
1	Moscow city	5531	100
2	SPB	3735	68
3	Moscow oblast	3529	64
4	Krasnodar krai	2985	54
5	Tatarstan Rep.	2950	53
6	Nizhnii Novgorod oblast	2924	53
7	Rostov oblast	2915	53
8	Sverdlovsk oblast	2896	52
9	Leningrad oblast	2885	52
10	Samara oblast	2821	51
11	Bashkortostan Rep.	2801	51
12	Voronezh oblast	2709	49
13	Saratov oblast	2700	49
14	Belgorod oblast	2666	48
15	Chelyabinsk oblast	2665	48
16	Novosibirsk oblast	2648	48
17	Dagestan Rep.	2637	48
18	Pskov oblast	2620	47
19	Kursk oblast	2620	47
20	Perm oblast	2591	47