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The Role of Risk as an FDI Barrier to Entry during Transition: The Case of Bulgaria

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Abstract: This article reports the results of a questionnaire that was designed to extract information regarding the determinants of foreign direct investment (FDI) in Bulgaria during the post-communist decade of the 1990s. We surveyed established multinationals in Bulgaria in order to discover their perceptions regarding the business environment. From the results of the survey, 52% of the total number of foreign investors stated that their investment in Bulgaria is of high risk. We explored whether the high risk environment in Bulgaria has been affected either by the foreign entry mode, the prior trade relations, the invested amount, the sector that the multinational operates, and finally the origin of the MNE.

Keywords: risk, foreign direct investment, FDI obstacles, multinationals, transition

JEL Classification Codes: F - International Economics, F21, F23

Survey studies present a valuable opportunity to contribute to economic research and are consistent with the methodology of institutional economics; particularly, surveys assist in understanding economic behavior that is often buried in a deeper context. In this tradition, a questionnaire was designed to extract valuable information regarding the determinants of foreign direct investment (FDI) in Bulgaria during the post-communist decade of the 1990s and especially after 1997. The policies introduced in 1997 proved to be the cornerstone of macroeconomic developments in Bulgaria which improved the business environment leading to the entrance to the European Union (EU) in 2007. The purpose of the survey was to discover the type of entry barriers for inward foreign direct investment considered by foreign multinationals

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(MNEs) in the late 1990s, in order to determine whether they should ultimately pursue an investment in Bulgaria. We surveyed established multinationals in Bulgaria to discover the perception of these existing MNEs regarding the business environment because these foreign companies have better knowledge of the business environment in the country where they are operating. These multinationals had to determine whether the business environment was risky or not as they would have to cope with the environment, and if they choose to undertake the risk to find ways to overcome this barrier.

Our sample was drawn from the 131 largest foreign investors in Bulgaria. Of these, 64 responded, for an overall response rate of 48.9%. From the results of the survey, 52% of the total number of foreign investors that responded stated that their investment in Bulgaria is of high risk. This paper investigates the level of importance multinationals place on the high risk environment in Bulgaria as a barrier to FDI. To this end, we address whether the high risk environment in Bulgaria has been affected by the foreign entry mode, the prior trade relations, the invested amount, the sector that the multinational operates, and finally, the origin of the MNE. Policy makers and students of both transition economies and international development would benefit from this novel approach, based on the questionnaire data, in determining the level of importance of the risk environment in Bulgaria for MNEs and consequently developing a more accurate policy response with the goal of further stimulating FDI in the country. The paper is structured as follows: the next section presents the survey design; it is followed by the results and analysis; and the paper concludes by providing the policy implications of our survey.

Survey Design

A questionnaire was designed to extract information regarding the determinants of FDI in Bulgaria during the post-communist decade of the 1990s. Its purpose was to identify the type of entry barriers for inward foreign direct investment considered by foreign MNEs in order to establish whether or not they should make an investment in Bulgaria. With the help of the official document from the Bulgarian Foreign Investment Agency (BFIA), a list of 110 foreign companies was created that according to the BFIA had invested over US$1 million in Bulgaria by the middle of June 1998. For the purpose of our survey, we extended the list to 131 by adding another 21 investors who were not part of the official BFIA list. As of 2007, these companies still remain among the top 150 biggest foreign investors in Bulgaria (InvestBulgaria Agency 2007).

Our sample was formed by the 64 companies of the 131 investors that responded (64/131=48.9%), an extremely high response rate. Moreover, because the sample was comprised of companies that had invested a very large amount of funds based on the economic figures provided by BFIA, it proved to be very representative. The volume invested by the 131 companies comprised 70% of the total foreign capital invested in Bulgaria. The total FDI inflows in Bulgaria were US$1.7 billion in mid-

1998. The total amount invested by the 110 foreign companies from the BFIA catalogue was US$1,283,419,173. The 21 enterprises that we added contributed an additional US$47.6 million. The sample of the 64 companies represents a total investment amount equal to US$863 million, which is 64.7% of the total investments of the 131 companies or 50.7% of the total Bulgarian FDI inflows (BFIA catalogue, Foreign Direct Investments over US$1 million, as of June 30, 1998). For the latest data for FDI inflows in Bulgaria see Table 1. Note that since Bulgaria has joined the EU, all the calculations are in Euros.

The questionnaire was originally based on the authors' knowledge of the ample literature regarding FDI theories and followed the Dunning (1988; 1993) theory in regards to possible reasons and entry barriers for foreign investment in Bulgaria (see also Bitzenis 2003). Moreover, it was enriched and updated according to the answers received from the investors over the course of time. The research was initiated in January 1998 and took 18 months to complete. The majority of the questionnaires were completed in the period between January 1999 and June 1999. The construction of the questionnaire was mainly based on Dunning's theory [the eclectic theory (OLI – eclectic paradigm of international production)], although the Universal model was also used (Bitzenis 2003). The usual way of replying to questionnaires, by post, failed as only 4.7% of the companies replied. The highest response rate came from one-on-one interviews (35.9% of the total), followed by e-mail and/or by visiting their website to obtain information. By exchanging e-mails with companies, information was provided to complete our questionnaire in conjunction with extra information obtained from annual reports, company's presentations, etc. A 29.7% total response rate was achieved. The fax and telephone methods together succeeded in about 30% of the cases.

The sample was determined on a quota basis (non random selection) involving the selection of subjects based on the identification of specific characteristics to increase representativeness. In quota sampling, the target population is divided into subgroups on the basis of different characteristics. Thus, in this case, we have created subgroups on the basis of companies from different types of industries, with different origins, and different volumes of investments (but always above US$1 million). Then a quota was determined for each subgroup. Thus, based on the criterion of the largest investment deals in Bulgaria, a quota was made with the help of the BFIA catalogue. The statistical analysis establishes possible relations between the variables for the 64 companies surveyed. The nature of the relationship between the variables, if any, was investigated using chi-square statistics, which is regarded as the most suitable for this type of data. Instead of using a statistical method like correlation coefficients that require data collection in a continuous form, the chi-square test allows for making inferences to the population of interest – in this case foreign investors in Bulgaria – by making use of the categorical data. The results are valid in most of the cases at the 0.01, 0.05 and 0.1 levels of significance and the inferences about the population were based on the results of the p-value (chi-square, Fisher's exact test, and continuity correction test).

Table 1: Total FDI inflows in Bulgaria 1996-2006 in million of Euros.

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006*	2007*
Total	**137.3**	**570.2**	**605.1**	**866.0**	**1103.3**	**903.4**	**980.0**	**1850.5**	**2735.9**	**3152.1**	**5961.0**	**6108.9**
Equity capital	131.1	556.1	569.4	527.9	838.7	627.0	631.6	1075.2	1831.9	1789.3	3179.5	3598.5
Other capital	6.3	13.7	-19.8	372.8	201.7	269.4	260.1	553.3	462.7	954.1	1949.6	2121.8
Reinvested earnings	0.0	0.4	55.6	-34.7	62.8	7.0	88.3	222.0	441.4	408.7	831.9	388.6

Source: Bulgarian National Bank

* The data are preliminary. Figures have been rounded to the first decimal.

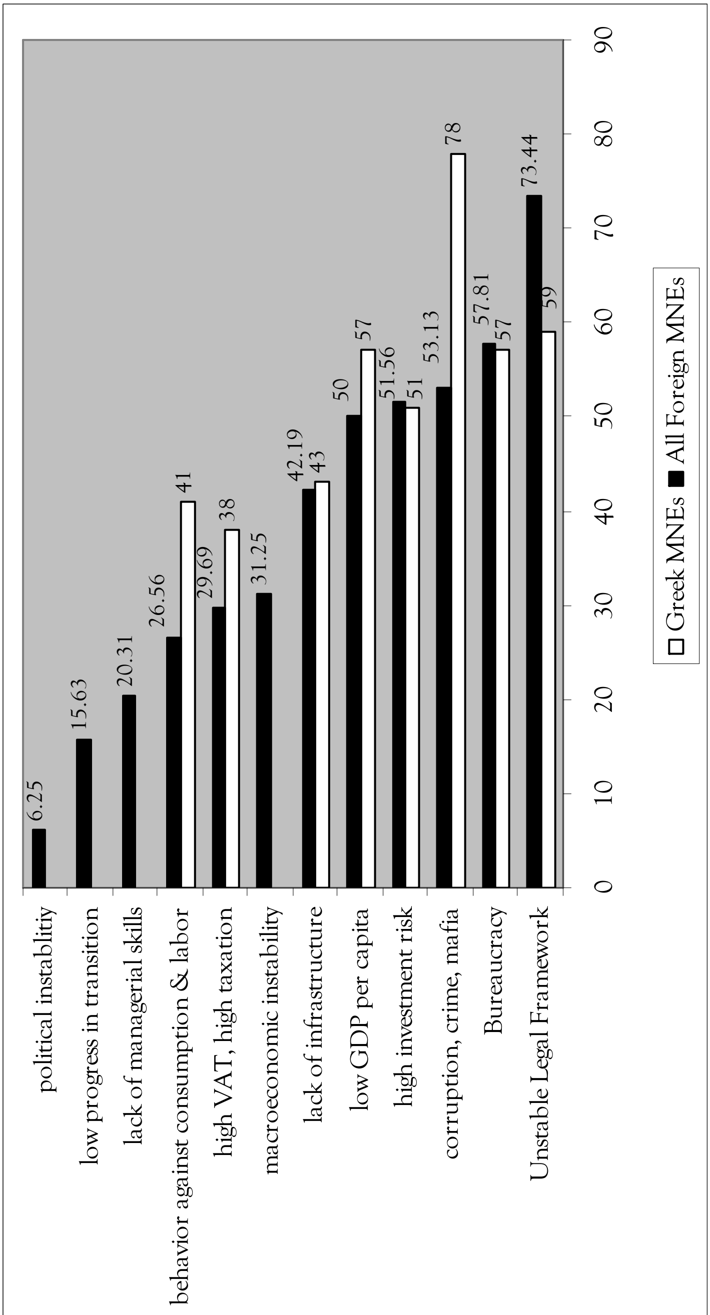
Results and Analysis

Managers of MNEs were asked to identify any number of obstacles, which they thought were crucial to their company's decision to undertake an FDI project in Bulgaria. It is important at this point to distinguish between uncertainty and risk embedded in the data. Uncertainty is linked with probabilities that MNEs attach a low weight of confidence about the measured quantity, because they simply do not know. In this case, the variables measuring obstacles are in part general and in part linked to the future. Risk is more quantifiable where the probabilities associated with low, medium or high profits have more weight or confidence. From the list of obstacles presented in Figure 1, a differentiation could be made along the following lines: variables associated with obstacles where more information is available (high Value Added Tax (VAT) and high taxation, lack of managerial skills, lack of infrastructure, low GDP per capita, bureaucracy); and variables associated with obstacles that are general in nature and/or concerning the future with little information available (political instability, low progress in transition, behavior against consumption and labor due to the legacy of communist regime, macroeconomic instability, high investment risk due to unstable business environment, corruption, crime, mafia and unstable legal framework).

The distinction between the varying level of risk and uncertainty can be linked with institutional and Post Keynesian themes. While risk cannot imply complete ignorance, the same applies to uncertainty as well. It is possible to denote different degrees of uncertainty. Individuals cannot know their level of ignorance. No standard of complete ignorance exists to provide a reference point. Yet, individuals are more ignorant in some cases than others, due to the presence and pervasiveness of stabilizing institutional procedures. Institutions have an important role in reducing uncertainty, as Keynes ([1936] 1967) and North (1990, 6) stressed. Hence, the varying degree of uncertainty, and of course risk, can be larger or lower in different situations depending on institutional practices (Dequech 1999, 417). From the results of the survey, 51.56% of the total number of investors stated that their investment in Bulgaria is of high risk (Figure 1). This paper will concentrate only on the investigation of the factors that determine why these investors stated that their investment in Bulgaria is of high risk.

According to the survey results, 23 of the 64 (35.9%) companies participated in a privatization program, at the same time in the period of the survey the official statistical data shows that the privatization deals provided almost 1/3 of the total FDI inflows in Bulgaria (Table 1 and Figure 2). Through privatization, MNEs could acquire a national company at a price that incorporates the risk premium and is lower than the price of similar companies that have been privatized in Western countries. MNEs generally acquired a Bulgarian national company at a low price, because of the underlying risk. Thus, the successful privatization deals and the low price of these deals led multinationals not to consider the Bulgarian business environment as risky, or at least not to acknowledge it as a barrier, because the companies incorporated the risk as a reason to acquire the state-owned companies at a lower price. Therefore, it

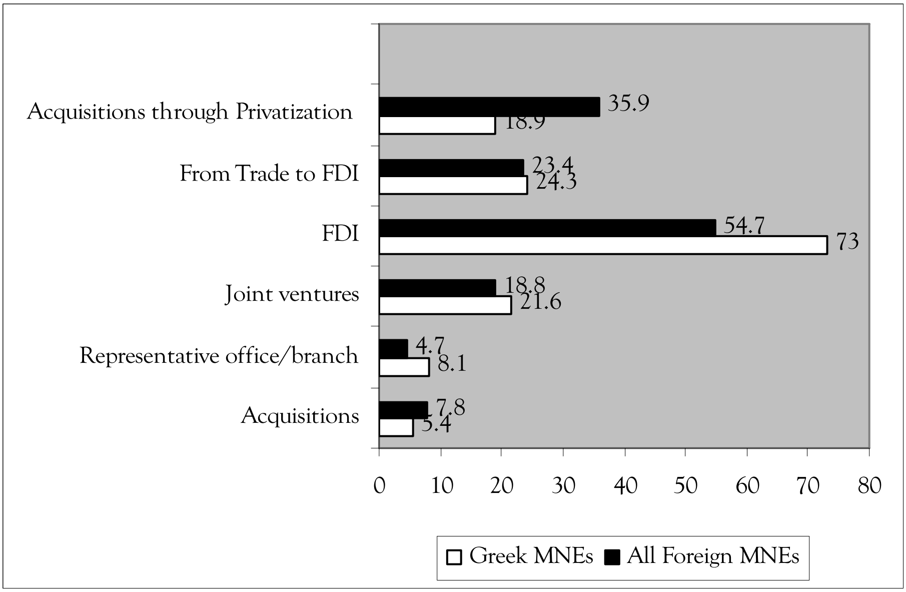
Figure 1: The Most Important Obstacles for Bulgarian FDI Inflows as a Percent of Responses from 64 MNEs



Source: Bitzenis (2006).

was an expected fact that half of the companies that established investments that took place through a privatization program (specific entry mode) did not consider the high investment risk as a barrier. Of the 23 MNEs that reported participation in the various Bulgarian privatizations programs, 12 (52.2%) did not characterize the Bulgarian environment as risky. However, while MNEs penetration via FDI as a percentage of private domestic investment has increased markedly, in general, in the Central and Eastern European region, domestic investment has more than halved between 1990-2002 and there has been a similar drop for real GDP relative to real world GDP (O'Hara 2006, 81). FDI is crowding out national investment, which in itself is one of the problems of the uncertain historical environment in Bulgaria as well, over the past two decades.

Figure 2: Entry Modes used by MNEs to Invest in Bulgaria as a Percent of Total Responses



Source: Bitzenis (2006).

From the statistical analysis, the authors did not find any statistical relation (any association) between most of the ways of undertaking investments (entry modes) and the high risk barrier (such as the type of Greenfield FDI and risk, acquisitions and risk, joint ventures and risk). This may be due to the fact that in their decision-making process to determine FDI before undertaking an investment project in this region, all MNEs recognized that Bulgaria belongs to a high risk region. Thus, the high risk environment was not a barrier but a reality to cope with.

Furthermore, another element that may affect the low consideration of risk as a barrier for an FDI inflow in Bulgaria is the existence of "prior trade relations." From the survey, the authors have also found that there is a statistical association and relation between MNEs that had prior trade relations with Bulgaria and the risky environment as a barrier. Fifteen out of 64 companies (23.4%) that invested in Bulgaria had prior trade relations and/or created an export base in Bulgaria. However, only three (20%) of those fifteen companies considered Bulgaria as a risky environment. In general, in our survey, 33 companies considered the Bulgarian business environment as a risky one. Nevertheless, only three of these 33 (9.1%) companies indicated prior trade relations with Bulgaria. This can be interpreted as prior trade relations provide the necessary experience to cope with the risky environment by supplying secure clients. From a statistical point of view, there is an association (at 5% level of significance) between risk and the type of investment that is the entry mode: moving from trade to FDI.

An unexpected result was that the volume of investment for each multinational did not play a role in the consideration of risk. The average amount of FDI inflows in Bulgaria was US$14.412 million. Only 13 companies that participated in the questionnaire indicated higher than average investments in Bulgaria; six (46%) of these considered Bulgaria as a high risk environment; of the 51 companies investing less than the average, 27 (53%) considered Bulgaria as a highly risky environment. According to the continuity correction test there is no association between the high risk environment variable as a barrier and the volume of the investment variable.

A small firm is more sensitive to the uncertainty-risk factor and small and medium enterprises (SMEs) are more likely to be risk-averse. The large MNEs are able to diversify the total risk, thus they diversify their activities in order to reduce and hedge the total risk (Buckley 1989; 1985). The small companies are more risk averse, the management is more biased by personal interests and feelings, and the goals are at a lower scale than those in large MNEs. However, the idiosyncrasy of the entrepreneurs of small companies may be more risky than the average or even more risky than those of large MNEs. From our research, 10 of the 13 (77%) companies that invested more than US$14 million by mid-1998 were also large MNEs in worldwide economic figures, and 13 of the 51 (25%) companies that invested less than the average of US$14 million were also large MNEs in worldwide economic figures. However, there is no argument based on our survey to underpin the fact that the large MNEs in worldwide economic figures undertake only or mainly risky investments, or in other words, that small firms are risk-averse. Thus, we argue that it is not necessary for a large MNE in worldwide economic figures to undertake only large FDI projects in a country such as Bulgaria (Bartlett 1993; 1996; Houbenova-Delissivkova, and Puchev 1996). Each investment should closely depend on the sector that the MNE belongs to, on local competition and on the investment plans and risk that the MNE is willing to undertake.

Twenty three companies participating in the survey belong to the industrial sector, 17 (74%) of these consider Bulgaria as a high risk environment. There are 18 companies from the services sector and 23 from the trade or food sector. Of these, 9 (50%) companies in the services sector and seven (30%) in the trade and food sector also consider Bulgaria as a high risk environment. As mentioned, little more than half of the total companies (33 of 64 or 51.6%) that participated in the survey also consider risk as a barrier for undertaking an FDI project in Bulgaria. From a statistical point of view, the p-value is <0.05, thus we accept the Ha hypothesis, and so, there is an association between the two variables, the type of business and the investment risk barrier at the 5% level of significance. It is concluded that risk depends on the sector in which each foreign company participates in Bulgaria. It has also been confirmed that companies in the trade sector are less concerned in risk as a barrier. This may be due to the fact that these companies are generally more risky companies or that the risky environment of Bulgaria will affect their activities less than the investment activities of the companies that belong to other sectors. Searching for the relationship between the origin of MNEs and the risk, the chi-square analysis demonstrates that there is no association between the two variables (origin of MNEs and the high investment risk barrier). It was a surprise to the authors that half of the MNEs of Greek origin, while having the experience of the Balkan business ethics and the experience to cope with the Balkan risky environment, mentioned high investment risk as a barrier (see also Bitzenis 2006). Thus, the consideration of risk in the decision making of an FDI project depends on the sector in which each foreign company operates in Bulgaria and not in the origin of MNEs. Furthermore, the risk does not always fully correspond with the amount that has been invested by the companies.

Conclusion: Policy Implications

We surveyed MNEs that had already invested in Bulgaria so as to discover whether they considered risk as a barrier to investment and whether they took risk into account as a barrier to the business environment in Bulgaria. In other words, if the business environment of Bulgaria is risky, then MNEs have to take some special measures to overcome it. Do they enter the Bulgarian market because it is risky, as the more risky the environment the more profits the investment will return? The more risky the environment the risk averse MNEs would leave space for the risk takers and, if successful, they gain the first mover advantage. Our results demonstrate that of the MNEs that participated in various Bulgarian privatization programs they did not mentioned the Bulgarian environment as a risky environment. Meanwhile, from a statistical analysis we concluded that there was no association between the remaining common ways of entry modes (such as the Greenfield FDI, acquisitions and joint ventures) and the barrier high risk. Prior trade relations provided the necessary experience to cope with the risky environment by providing secure clients. The volume of investment for each multinational did not play a role in the consideration of risk. Large MNEs in worldwide economic figures mainly undertake large investments in Bulgaria, but these MNEs did not necessarily consider their investments as risky FDI projects in a country such as Bulgaria. Risk depends on the sector in which each foreign company participates in Bulgaria and the companies in the trade sector are less interested in risk as a barrier. Finally, there is no association between the origin of MNEs and the risk. A decisive policy that can be suggested in this paper is that Bulgaria should employ a tailor-made approach, accounting for the specifics of the targeted sectors and encouraging prior trade relations as a means of entering the Bulgarian market. We strongly believe that generalized investment promotion policies and strategies might not work equally well for all sectors of the economy and might have no impact on attracting FDI in particular cases.

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