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## **FDI Integration in a Transition-Country Environment: the Case of Bulgaria**

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### **Introduction**

The impact of FDI on the recipient country's economy is usually regarded as having beneficial effects on the host economy. However evidence from numerous studies of FDI spillovers is mixed (Aitken, Harrison [1999]; Gorg, Greenaway [2004]). Various channels permitting the realisation of the potential positive spillovers from foreign companies to domestic economy have been identified in the literature on FDI effects but the knowledge about their relative importance and the understanding of the nature of linkages generated by foreign firms still need a deeper investigation.

The objective of this paper is to study one of the possible spillover channels, namely the collaboration of foreign firms with local ones because of the direct learning effect it may entail. The analysis focuses on the inter-firm relations established by European Union investors in the manufacturing sector in Bulgaria with their suppliers in the country. Our aim here is twofold: first, to identify foreign investors' suppliers of raw materials and components for their production; second, to analyse the influence of the institutional environment quality on the choice of suppliers as a way to secure the respect of agreements by selecting reliable partners.

The first issue will allow the investigation of the interaction of European Union investors with local suppliers in Bulgaria in an attempt to establish the existence of a preference for the type of supplier (local or foreign) for supplies. This represents an important indicator for the functioning and the scope of this spillover channel. Backward linkages are a major means for transmission of technological and management know-how from foreign investors to domestic firms but their scope and intensity vary greatly depending on factors such as investor's characteristics, foreign company's entry strategy and type of subsidiary (Javorcik [2004], Jindra, Giroud, Scott-Kennel [2009]). As Bulgaria integrated into the European Union in 2007, the collaboration with an experienced European Union partner could represent a strong

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factor for upgrading the work of Bulgarian enterprises and their integration in the larger European market.

Drawing on the new institutional economics which underlines the importance of the quality of institutional environment for the realisation of transactions, the paper offers also an analysis of the influence of institutions on inter-firm relations (Oxley [1999], Hadfield [2005], Johnson, McMillan, Woodruff [2002]). Weak contract enforcement and short firm history, characteristic for transition economies, may encourage turning to better known foreign suppliers and the avoidance of more “risky” domestic firms. Thus, the foreign subsidiaries’ perception of domestic institutions is taken into account as it might reveal a strong determinant of the nature of backward linkages with local firms. The issue is of special interest as Bulgaria as a new member of the EU is currently struggling to improve the competitiveness of its economy as well as the working of its institutions among which judicial system’s efficiency and impartiality are questioned particularly often.

The analysis is based on an original extensive firm-level survey of manufacturing firms established in Bulgaria and owned by a European Union company. The survey is complemented with the results from in-depth interviews with foreign firms’ managers and other public and private actors taking part in the foreign investment establishment and operation in Bulgaria.

The paper is organised as follows. After a short overview of the potential benefits from FDI for the developing countries and the empirical evidence on that issue, we concentrate on the possibilities for positive spillovers from FDI to domestic economies through vertical (in particular backward) linkages. The second part is devoted to the determinants of the choice of suppliers by foreign companies in respect to institutional environment conditions and the characteristics of the investment project. A short description of the data gathering methodology and of the variables follows in section 3. The results are presented in section 4.

### **I. FDI, a lot of expectations**

After an initially quite reserved and hesitant behaviour of host country governments towards FDI, the attitudes radically changed in the 80s when FDI started to be seen a major growth driver especially for developing countries (UNCTAD [1993]; Dunning, Narula [2004]). This very positive view of the impact of FDI on host economies is well summarised by the World Bank [1993] which stated that “[FDI] brings with it considerable benefits: technology transfer, management know-how, and export marketing access. Many developing countries will need to be more effective in attracting FDI flows if they are to close the technology gap with high-income countries, upgrade managerial skills, and develop their export markets.” Consequently, in 1999, FDI was “avidly sought by governments and, indeed, many sub-national public sector entities at all levels” (UNCTAD [1999]). As for many other countries, in Bulgaria, promoting FDI became a central feature of government programs (Iankova, Katz [2003]).

Following this line of thought many analyses were devoted to the FDI phenomenon in order to identify its determinants, to assess its impact on host economies and to elaborate the best policies for attracting it. However, despite the theoretically clear benefits for host countries from FDI, the empirical studies on positive spillovers to domestic economies resulted in a very mixed picture and no clear conclusions. This misalignment between theory and empirical

tests prompted further reflection on the interaction between multinational enterprises and host economies to which the present article aims to make a contribution.

### *1.1. Where do positive spillovers come from?*

Why is FDI so desired by host countries? There are two ways in which foreign investment can contribute to host countries' economies: it is source of fresh capitals and know-how externalities leading to up-to-date technology, management, marketing etc. dissemination. Although the provision of financial capital is an important positive aspect of FDI, particularly for developing countries where capital resources are scarce, it is from the second point that ensue the most valuable long-term benefits for local economies (Dunning, Narula [2004]). Multinationals have to be more efficient, to possess better technology and management knowledge than domestic firms in order to compete successfully with the latter despite the disadvantage of operating in foreign environment. The objective of attracting foreign investors is the transfer of those advantages to local companies which would result in improved competitiveness of the domestic firms and therefore in higher growth.

The assumption of better performing foreign enterprises has been confirmed by a number of studies (Aitken, Harrison [1999]; Konings [1999]; Damijan, Rojec [2004]) and analyses have tried to identify the positive spillover channels and to quantify their effect on the host economy. The following channels are largely considered in the literature (Aitken, Harrison [1999]; Gorg, Greenaway [2004]; Javorcik [2004]; Alfaro, Charlton [2007]):

- Training of employees by multinationals their movement to domestic firms creates an opportunity for diffusion of new knowledge;
- Local firms can improve their operation or technology by observing and imitating multinationals present on the market;
- Increasing competition due to the foreign companies puts pressure on local firms to work more efficiently or adopt new technologies;
- The presence of multinationals on market creates additional demand for domestic companies providing intermediate products and supporting activities;
- Possibility for domestic firms to learn how to penetrate export markets by collaborating with or by copying foreign firms.

For developing countries the entry of multinational enterprises could also play an important role in changing mentalities by injecting more market-oriented values and practices (Dunning, Rojec [1993]). However, although there is general agreement on the nature of the spillover channels, there is little about their relative importance (Blomström, Globerman, Kokko [2000]).

Many studies have tried to empirically verify the existence of those channels and to quantify their impact on host economies using different methodologies: case studies; industry-level studies; research based on firm-level data (Javorcik [2004], 605-606) but whatever the methodology, the resulting conclusions are rather mixed. Although several analyses effectively record positive spillover effects from FDI, there are also a number of works that find no or mixed evidence (Aitken, Harrison [1999]; Gorg, Greenaway [2004]; Lipsey [2004]; Damijan, Rojec [2004]; Konings [1999]; Alfaro, Charlton [2007]). Therefore, it appears that the impact of FDI on host country varies considerably depending on country and time period considered.

This discrepancy between the theoretically expected positive impact and the inconclusive empirical results motivated recent studies trying to explain the variability of the findings so far. Several explanations have been put forward. One possibility is the existence of negative effects from the presence of multinational companies on domestic ones or the impossibility for domestic companies to benefit from the proximity with foreign subsidiaries. For example, the competitive pressure the former create may result not in the improvement of local firms and thus in higher efficiency, but in their ousting from the market (Andreff [2003]; UNCTAD [2006]). Or, foreign and domestic companies could work for different segments of the market (or respectively for foreign and domestic markets) which impedes the creation of a competition effect. In addition, as salaries are generally higher in MNEs (Brown, Deardorff, Stern [2004]; Lipsey [2004]; Farrell, Remes, Schulz [2004]; UNCTAD [2006]), the most qualified and efficient workers are attracted by and stay in foreign companies, leaving local firms with less good workforce and limiting the transfer of know-how.

Another type of explanations is oriented towards the capacity of the home country companies to benefit from the presence of MNEs. If the technological distance between foreign and local firms is too big, the domestic firms will have more difficulties to copy foreign subsidiaries and hence, to upgrade their production and management procedures by adopting those of the more advanced foreign companies.

These observations indicate that the existence of potential spillover channels does not mean that FDI will necessarily have the desired positive impact on the host economy. As Dunning and Narula [2004] point out “FDI per se do not provide growth opportunities”. The right kind has to be attracted and the domestic economy must have the capacity to absorb the spillovers if the positive impact on its development is to be realised. Hence, the analysis of the degree and the nature of the interactions of the foreign investors with the host economy is a central point in the realisation of positive spillovers that could significantly contribute for a better understanding of the extent of FDI impact.

### ***1.2. The importance of vertical linkages***

In addition to the above mentioned possible explanations for the inconclusive results from empirical tests, some analyses suggest that research is probably looking for positive spillovers in the wrong place as most works concentrate on assessing intra-industry effects from FDI. Spillovers in the same sector of activity being externalities of the functioning of the MNEs, strategies for preserving competitive advantages could be the reason for the absence of systematic positive influence on domestic firms. Several authors suggest that foreign affiliates try to prevent leakages of their ownership advantages to their competitors (Javorcik [2004]; Blalock, Gertler [2008]) and hence, strongly limit the impact on the host economy. In contrast, this is not the case when it is question of transferring technology and management know-how through vertical linkages<sup>2</sup> where the recipients are not company's competitors.

Besides, foreign subsidiaries may benefit from leakages and transfers to suppliers in upstream industries because their partners become more efficient. Therefore, positive effects from FDI are much more likely to materialise from vertical relations between a foreign company and its

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<sup>2</sup> UNCTAD [2001] p. 127: Such linkages can take several forms: *backward*, *forward* or *horizontal*. *Backward linkages* exist when foreign affiliates acquire goods or services from domestic firms, and *forward linkages* when foreign affiliates sell goods or services to domestic firms. *Horizontal linkages* involve interactions with domestic firms engaged in competing activities.

local partners than in the same sector (Kugler [2006]; UNCTAD [2001]). Hence, studies on FDI impact turned to the analysis of inter-industry spillovers and the explanation of the mechanisms of technology and knowledge transfer through forward and backward linkages with local firms. The general idea<sup>3</sup> underlying this line of research is that MNEs' subsidiaries being more productive than the local firms, they create a ratchet effect on domestic suppliers and clients (Andreff [2003]; UNCTAD [2001]). Javorcik [2004] identifies three ways of transmission to local firms: 1) direct knowledge transfer to local suppliers; 2) higher requirements for product quality and on-time delivery providing incentives to domestic suppliers to upgrade their production management and/or technology; and 3) growing demand for intermediate products, which helps local suppliers' development.

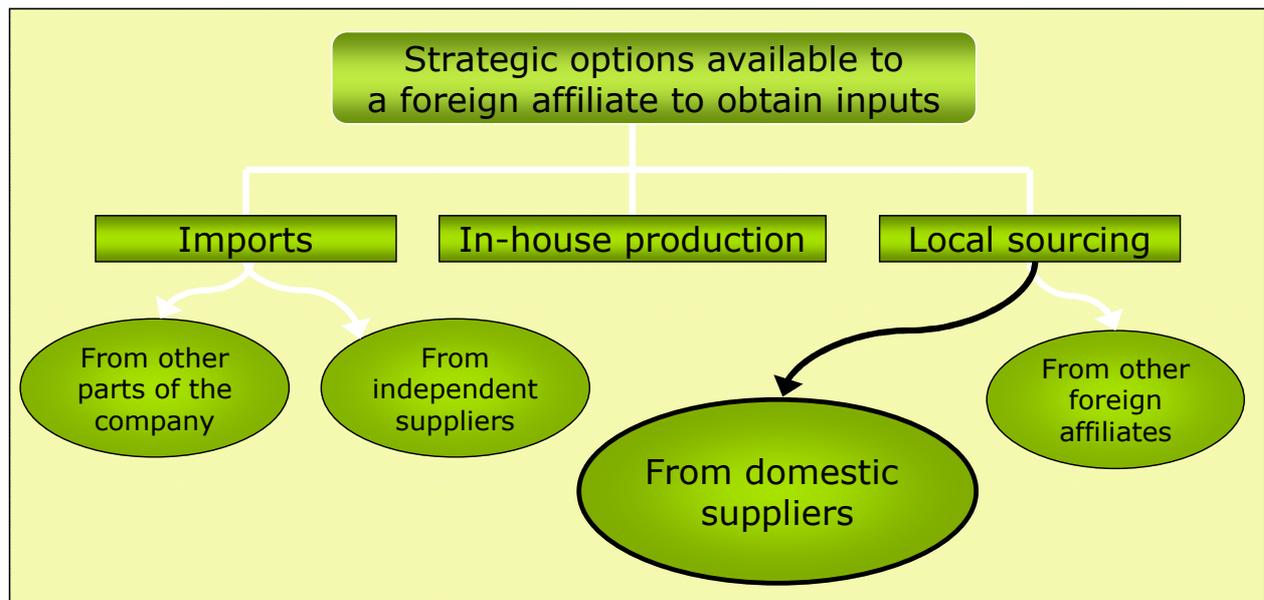
Empirical studies show that the backward linkages channel is effectively functioning while evidence for spillovers from forward linkages is missing (Kugler [2006]; Konnings [1999]). Hence, theory and empirical findings so far suggest that the main way foreign establishments exercise positive influence on domestic firms is through relations with suppliers. Furthermore, as Blalock and Gertler [2008] emphasize, inter-industry spillovers are not limited to the direct upgrading of local suppliers but include also increases in productivity of other domestic firms that benefit from the improved quality of the work of MNE suppliers. Thus, the positive impact from FDI on the host economy is larger than just the ameliorations in supplier firms.

So, direct contacts with local firms are essential for positive spillovers to take place (Chen and al. [2004]; UNCTAD [2001]). However, even though a country can attract an important quantity of foreign investment the realisation of a large positive effect of domestic firms is far from guaranteed as backward linkages will not necessarily be created even in manufacturing. Contracting with domestic companies is only an option among others for the subsidiary for procuring itself the inputs for its activity (Figure 1). Three possibilities open for the foreign investor: import from abroad inputs, produce inputs in-house and search for local suppliers that may well be other foreign affiliates. Depending on the choice of the MNE, the degree of interaction with the local economy is quite uneven as well as the benefits for the latter. As Kugler [2006] points out "Without local outsourcing by MNCs, for example if all subsidiary inputs were either imported or produced in-house, widespread FDI spillovers would not materialize". Thus, FDI activity may not have a notable improving impact on the domestic economy even if it leads to an increase of productivity and exports, if it has little interactions with its environment.

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<sup>3</sup> For a formalised presentation of the influence of foreign companies on host economies, see Rodriguez-Clare [1996].

**Figure 1**



So, to be able to design adequate policies that encourage the establishment of backward linkages in order to stimulate technology and general know-how dissemination in host economies, the understanding of the choice of suppliers of foreign investors is essential. Of course, a decisive condition is the existence of domestic suppliers able to procure the necessary inputs corresponding to the requirements of the MNE. If domestic companies' capabilities are weak (for example, an important technology gap), there is a strong risk that few linkages will be created (UNCTAD [2001, 2006]). However, various studies indicate that the preferences of the foreign subsidiaries concerning the choice of suppliers depend on the characteristics and the motivations of the investment project. The objective of the present paper is to contribute to the understanding of the factors that influence the relations between foreign affiliates and domestic suppliers with a firm-level study of the linkages created by European Union companies' affiliates in the Bulgarian manufacturing sector. In the next section, we will look closer into those determinants.

## **II. Determinants of choice of partners**

The choice of the suppliers is most often driven by considerations related to the “essential trio of price, quality and delays” as a company manager put it. But those parameters can disguise other dimensions that can also orient the decision. The characteristics of the investment projects open different possibilities for finding partners. Several aspects of the institutional environment such as regulations concerning the foreign company's activity and courts' efficiency in enforcing contracts can also modify the preferences concerning partners. The reliability of the partner in terms of respect of agreements and readiness to cooperate in case of unforeseen events and need of contract changes could also strongly influence the decision. In this section, two groups of factors (investment related and context related) and their effects on the creation of backward linkages are considered.

### **2.1. Characteristics of FDI**

Following existing FDI analyses, three features of the investment project are taken into account: the reasons for the investment, the entry mode and the role of the subsidiary in the multinational company's structure.

### **2.1.1. Investment motivations**

The degree of embeddedness of a foreign subsidiary is plausibly strongly influenced in the first place by the reasons for the company to engage in foreign direct investment. The interactions with the host economy would be of different extent and intensity when the foreign company is making a significant long-term investment in order to establish itself on the local and regional markets and when it is making a more footloose investment looking for benefits from low cost labour or exchange rates, thus influencing the impact of the FDI on the domestic firms. Therefore, the entry strategy of the foreign company is an important cause that should be considered when analysing the creation of linkages between the foreign company and the domestic suppliers.

The reasons for a company to invest abroad are various and specific combinations of factors have been decisive for each of them. Nonetheless, depending on the motivations, four categories of foreign investment have been identified in the literature (Berhman [1984]; Dunning, Narula [2004]; Eckert, Rossmeyssl [2004]): resource-seeking, market-seeking, efficiency-seeking and strategic asset-seeking investments. Each of these entry strategies is supposed to be characterised by a different level of intertwining with local firms and hence, by a different degree of impact on the host economy. If the establishment of vertical linkages is essential for the realisation of positive spillovers from FDI, the understanding that the relation between the entry strategy and the choice of suppliers is of primary importance for the design of foreign investment policies as the potential benefits for the host country seem to strongly depend on the degree of integration of the foreign subsidiary in its economy.

Dunning and Rojec's [1994] analysis indicates that the creation of backward linkages is most likely in the cases of market-seeking investment. When MNE's objective is to establish its brands in a new market, working with local suppliers avoids transportation costs and helps close contacts and cooperation with them. As market-seeking investments mean that the company aims in operating in the host country for a relatively long period, the costs of finding appropriate partners can be offset by the length of the relation and the gains from easier interactions with suppliers. In these cases, the foreign subsidiary benefits from working with more efficient partners possessing up-to-date technology and it is in its interest to assist its suppliers. For that reason it seems most likely for positive influence from FDI to materialize when the investment is looking for taking market positions.

In contrast, the creation of relations with local suppliers is much more uncertain when natural resource-seeking investment and efficiency seeking investment are concerned (Dunning, Rojec [1994]). The advantages of building durable relations with domestic firms are less clear for these often more volatile subsidiaries and may even be incompatible with the structure and the functioning of the foreign company<sup>4</sup>. The preferences for suppliers of subsidiaries created by strategic asset-seeking investment are even more difficult to predict as this kind of investment covers a particularly large variety of situations. Hence, the presence of backward linkages with domestic firms in cases of market-seeking investment could be expected while it is much less probable with the other types of investment.

An alternative distinction of investment motivations has been used in some more recent works on FDI impact on host countries (UNCTAD [2001]; Javorcik [2004]; UNCTAD [2006];

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<sup>4</sup> For example, in the case of an efficiency-seeking investment of a company which has an integrated production across countries there can be little room for domestic suppliers. The same is valid for MNEs which rely on global sourcing.

Jindra and al. [2008]). The accent is put on the current orientation of the foreign subsidiary: domestic market-oriented or export-oriented. The reasoning is that the requirements towards the suppliers could vary depending on the market served by the foreign subsidiary. It has been suggested that export-oriented companies have higher needs in terms of quality that could be difficult to meet for domestic suppliers especially in developing countries. In contrast, local firms have better knowledge of domestic market preferences and thus, working with them could be advantageous for domestic market-oriented subsidiaries. However, empirical tests (Javorcik [2004], Jindra and al. [2008]) have not led to clear-cut results on that point.

As both approaches of foreign investment motivations expect market-seeking foreign companies to be more prone to establish backward linkages compared to other categories of investments, the following proposition is formulated:

***H1. Market-seeking foreign subsidiaries will be more prone to work with domestic suppliers than other subsidiaries.***

### **2.1.2. Entry mode**

The way a MNE establishes its operations in a new country is another company-related factor that can condition the interactions with local suppliers as the facility to gather information and to enter local networks differ upon the chosen entry mode. In the case of Bulgaria, the foreign investor is entering a transition country characterised by rapidly evolving economic environment where information about potential partners is scarce and enterprises' histories are often short. As in cases of weak market-supporting institutions, personalised networks replace them in their functions of information and contract enforcement provision (Peng, Luo [2000]; Meyer [2001]; Gradeva, Menard [2008], McMillan, Woodruff [2002]), the insertion in those networks could represent an important step greatly facilitating the identification of suitable domestic suppliers and the work with them. Therefore, starting a completely new venture or relying on already existing enterprise with established network of partners is not neutral for the preference for local sourcing of the foreign subsidiaries. While a new foreign firm created by greenfield investment will supposedly have little or no connections on the domestic market, an acquisition will not begin interactions with local partners from scratch.

There are two primary modes of foreign direct investment (FDI): greenfield and acquisition. A greenfield project gives the investor the opportunity to create an entirely new organization adapted to its own requirements while the acquisition of an already existing firm facilitates quick entry in the new market. In the context of CEE countries, in particular in the beginning of the transition, the options were modified into a "privatisation or greenfield" choice and foreign investment was closely linked to privatisation (Dunning, Rojec [1993]). The privatisations of the inefficient socialist enterprises often corresponded to the characteristics of what Meyer and Estrin [2001] called brown-field investment. The distinguishing feature of a brownfield investment is that this is a hybrid entry mode in which the foreign company acquires a local one but proceeds to a deep restructuring resulting in a new operation with the characteristics of the investor (as with a greenfield investment) offering little continuity for the local firm. As the private sector developed in CEEC, acquisitions took their more classical form of a company taking control of another private firm without necessarily building anew the local firm.

The entry in the host country market via acquisition can be considered the easiest as far as the establishment of relation with local partners is concerned. When a MNE acquires a domestic company, there is already experienced staff with good knowledge of the market and the

environment as well as existing working relations with suppliers that lower transaction costs and make possible the reliance on trust based on repeated transactions and informal relations. Therefore, even though the foreign investor can choose to completely change the partners of the company, it is still likely that the firm continues to work or starts working with Bulgarian suppliers as it already has some reputation and links with the domestic economy.

The prospects for local sourcing of privatised companies are somewhat different. As mentioned above, during the privatisation period in the CEE countries, when the foreign investor got the property rights over the enterprise, this was often followed by a deep reorganisation of the company. Hence, the arrival of the foreign owners can represent a major disruption in the relations between the privatised company and its suppliers especially when taking into account the fact that probably most of the suppliers were undertaking the same type of profound restructuring subsequent to privatisation more or less at the same time. In consequence, foreign subsidiaries created by privatisation, can benefit from the linkages and the knowledge about the domestic market of the acquired firm but we may expect them to use local suppliers to a lesser extent than the acquisitions of already private firms as the costs of finding them are higher and the respect of the agreements more uncertain.

Greenfield investments seem to be those that should encounter the most serious difficulties in integrating domestic economy as this kind of subsidiaries do not have previous knowledge on their new environment nor can rely on already existing relations with local partners (Meyer [2001]). Therefore, establishing relations with domestic suppliers could turn into a complex exercise entailing important transaction costs, especially in a rapidly changing transition economy such as Bulgaria where information is scarce and firms' lifespan can be extremely short. Thus, greenfield investors may have to choose between finding and contracting with unknown domestic suppliers and working with foreign suppliers on which information is available and with which the company maybe already has or has had partnerships. Following previous studies (Jindra and al. [2008]), we expect that greenfield projects work mostly on other foreign companies.

***H2. Greenfield investment will be less likely to work with local suppliers than acquisitions.***

***H3. Privatisation subsidiaries will be less prone to use local suppliers than other acquisitions.***

### **2.1.3. Autonomy of the subsidiary**

The roles of subsidiaries may vary even within the same MNE network. The type of a subsidiary is characterised by the scope of the activities it realises and by its level of competence on them (Benito and al. [2003]). This is an important factor because the possibilities for local sourcing depend on the degree of autonomy a subsidiary is given by the parent company (UNCTAD [2001]; Jindra and al. [2008]). "The nature of the activities undertaken by a subsidiary and its potential level of embeddedness in the host economy vary according to the level of its competence and to the scope of its activities" (Dunning, Narula [2004]).

If the subsidiary is highly integrated in the parent company and therefore, strictly controlled, there might be little room for search and choice of domestic suppliers. For example, the parent firm may have the practice of a centralized procurement in which case, linkages with local suppliers will not be created. The subsidiary established in Bulgaria may not have the decision power to choose its suppliers by itself or may have only a limited one. On the contrary, when the subsidiary has key strategic functions, it is much more likely that it has the mandate to

make itself decisions on a number of important issues and not be limited only to simple operational choices (Roth, Morrison [1993]).

#### ***H4. Autonomous subsidiaries will work more often with domestic suppliers.***

##### ***2.2. Institutional environment***

Although a number of factors are usually taken into account when analysing the diffusion of know-how and technology from MNEs to the host economy, an important dimension which could exercise a strong influence on the decision to establish relations with local suppliers is often missing (Oxley [1999]). The quality of institutions as perceived by the decision-makers in the firms could represent an essential determinant of the creation of backward linkages. As for any firm, it is important for a MNE to find reliable suppliers that can guarantee on-time deliveries of materials corresponding to its requirements. This may be difficult especially in a developing country if there is a technological gap between MNEs and local firms. Besides technological capabilities, the possibility to prevent partners' opportunism is a factor that could direct the choice of supplier in a situation where potential suppliers include both local and foreign firms.

In developing countries where public legal institutions often cannot guarantee contract enforcement, credible commitment through written contracts becomes difficult to achieve. The role of the contract is to guarantee the realisation of a transaction following the terms agreed upon by the parties and to prevent potential opportunism of parties. The contract relies on public institutions which must be able to enforce it in case of complaint of a party. However, in the case of developing countries the legal system might not be able to ensure the respect of the contract. Therefore, in a context where public enforcement of agreements might not be reliable, the firms will look for alternatives to manage their interactions.

There are different ways of guaranteeing respect of agreements: formal public, formal private and informal private. When arriving in a new country without having previous knowledge about local firms and practices, MNEs cannot rely on informal networks. Therefore, they have to make formal contracts with their suppliers in order to ensure deliveries. If these are to be reliable, the efficiency of the public enforcement system is central. In a context, as in Bulgaria, where the legal system is one of the institutions that are often cited as one of the most troubled, the public enforcement might not be seen as a reliable way of guaranteeing contracts. Therefore, the perception of the quality of the judiciary of the firms' managers may influence their choice of partners. The work of the legal system becomes all the more important in the case of Bulgaria where the transition period was marked by important turmoil. The late economic stabilisation of the country (which came only in 1998 with the introduction of a currency board) and the delays in the reforms made for short firm histories and lack of information about them.

Some studies show that in Bulgaria, many (particularly small-size) firms rely on informal relations with partners and avoid formal (especially long-term) contracting (Gradeva, Menard [2008]; Koford, Miller [2006]; Stark [1996]; Meyer [2001]). This option may not exist for MNEs if they do not have previous experience in the country, neither established relations with local suppliers. Thus, if a contract with relatively unknown domestic firm seems too risky because of the limited information available and/or the perceived difficulty to enforce the contract in case of opportunism, the foreign affiliate might prefer to turn to a better known foreign supplier. If the supplier is another MNE, its incentives to respect the agreement could be higher due to the fact that the negative effect on reputation from an opportunistic action

will be larger than for a local firm. Therefore, the choice of a well-known supplier could in this situation be seen as a way of prevention of opportunism in a situation of weak public contract enforcement by choosing partners that have much more to lose from an eventual break-up of the relation as the two companies maybe collaborate together on other markets.

***H5. Foreign companies perceiving courts as inefficient will be more prone to work with foreign suppliers.***

A second relevant factor related to public institutions is the frequency of the changes in regulations concerning foreign companies' activities. Repeated modifications in the legislative framework on production activities may result in continuous adjustments of the agreements between the foreign firm in Bulgaria and its suppliers. Therefore, working with well-known partner that is more interested in a smooth proceeding relation and with whom routines have been established, could give important advantages to foreign suppliers in the competition for foreign subsidiaries' orders. On the one hand, existing suppliers may have more incentives to act cooperatively than newly established ones because of established informal relation and higher stakes. On the other hand, the routines created thanks to repeated transactions with a partner allow minimising transaction costs related to the adaptation of agreements.

***H6. Frequent regulatory changes will reinforce preferences for foreign suppliers.***

The general perception of the potential Bulgarian partners could also be a factor in the process of partners' selection. If managers of foreign companies believe that most of the local firms are unreliable and that therefore, finding trustworthy suppliers will be difficult and involving considerable amount of research transaction costs, they would choose to rely on international companies having established reputation and avoid altogether contracting with local firms seen as more "risky".

***H7. A perception of the local suppliers as unreliable will discourage the creation of backward linkages with them.***

### **III. Data and variables**

#### ***3.1. The survey***

The analysis is based on an extensive survey on the manufacturing companies owned by a European multinational in Bulgaria i.e. with a primary activity code from 1511 to 3720 (Manufacturing) from the National Classification of Economic Activities 2003. Manufacturing is the sector with second largest FDI inflows following real estate. As the objective of the paper is to study the practices of foreign investors with regard to backward linkages with domestic companies, only companies with at least 50% foreign ownership were included in the sample<sup>5</sup>. The survey was realised from March to May 2009 as standardised face-to-face interview with senior managers of those firms. The main difficulty of the

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<sup>5</sup> In the literature, the criteria for a company to be included in surveys on FDI related issues, is often more than 10% foreign ownership (Javorcik [2004]). However, in order to make conclusions about the preferences of the foreign investors, it seemed more appropriate to take into account only the firms for which the foreign ownership is a decisive factor (hence, at least 50% share). The choices of enterprises where the foreign investor has minority participation do not necessarily reflect the presence of the multinational as other factors such as the balance of power among holders.

realisation of the survey was to find a reliable database containing all companies corresponding to those criteria. The problem encountered is quite illustrative of the complications entailed by institutional instability.

To operate in Bulgaria, a firm has to be registered in the national register BULSTAT managed by the National Registry Agency functioning under the authority of the Ministry of Justice. However, BULSTAT did not update information about firms and a significant proportion of the companies present in the register do not function any more. The need for centralised, publicly accessible and up to date information about the enterprises in Bulgaria was one of the reasons to establish a new Commercial Register that replaced BULSTAT from January 1<sup>st</sup>, 2008. The registration in the new register is compulsory for newly established commercial firms and re-registration of already existing firms has to be done within a three years period. Thus, until the end of 2010, there is no mean to obtain a truly complete list of the foreign companies in Bulgaria.

The construction of the sample went through several steps in order to get round these difficulties. An initial list of the manufacturing firms with 50% and more European ownership was taken from the BULSTAT register. 697 firms corresponded to these criteria. For each firm the database contains information about its national identification number, the activity code as of the National Classification of Economic Activities 2003, the economic activity sector, addresses of the head office and sometimes of the place of production, structure of ownership of the firm (names, country and percentage of ownership of the owners) and date of re-registration in the Commercial Register. The fact that the firms in the sample already existed in December 2007 guarantees certain experience in the Bulgarian economic and institutional environment which is necessary to be able to complete the questionnaire.

As BULSTAT did not systematically gather information about firms after their registration, the risk of the presence of numerous phantom firms in the initial database was high. To take this into account, the enterprises that did not have re-registered in 2008 were excluded. This means that some existing foreign firms may still not be re-registered and thus are omitted in our list. However, the re-registration being compulsory, it is plausible to think that the vast majority of operating foreign firms would do it within the first year and few of them will wait for longer. This is supported by the steadily declining numbers of registrations at the end of 2008 and January 2009. Further checks for changes in firms' situation, such as change of address, bankruptcy and so on that could have occurred in 2008, were made for each entry in the Commercial Register to update the database. In this way, closed firms or those in liquidation were also excluded. At the same time, the activity code was converted following the new Classification of Economic Activities that came into effect January 1<sup>st</sup>, 2008<sup>6</sup>. This additional verification allowed the elimination from the final database of those firms whose activity is no more considered as part of the Manufacturing category.

The resulting database contained 354 functioning predominantly foreign manufacturing enterprises on the territory of Bulgaria in January 2009. All of them were approached by the

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<sup>6</sup> Класификация на икономическите дейности - 2008 (Classification of Economic Activities – 2008), National Statistical Institute, 2008. The new classification was introduced to reflect the changes in the European Union statistical classification of the economic activities NACE Rev.2. The conversion and the update of the firms' activity code were complicated by two factors: first, by the extremely incomplete information on this issue in the Commercial Register where the code is missing in most cases and where, when it was present, the use of both the obsolete and the current classification was observed; and second, by the practice of Bulgarian firms to enumerate all kinds of activities in the description field generally ending by "and all other economic activities not prohibited by the Bulgarian law".

interviewers and that resulted in 125 completed questionnaires. This accounts for a 35% response rate which may be considered satisfactory.

### 3.2. *Dependent variables*

The questionnaire allows the construction of two measures for backward linkages with local suppliers. The first indicator for the extent of the interactions with domestic firms is the share of materials bought from Bulgarian suppliers in the total of the deliveries received by the foreign company. This variable captures the extent of a general reliance of foreign companies on Bulgarian partners for the materials necessary for their production. The variable (Table 1) takes five values: no Bulgarian supplies, minority Bulgarian supplies, around half of the supplies, majority Bulgarian supplies, wholly Bulgarian supplies. The data shows that relatively few European companies in Bulgaria get their supplies predominantly or entirely from domestic suppliers (around 25%) and that for nearly 40% the share of Bulgarian materials represents less 10%. A very significant fact is that nearly 19% of the European investors do not contract at all their supplies with Bulgarian producers. Therefore, it seems that in Bulgaria the linkages established between the European companies' subsidiaries and the domestic producers are rather rare.

**Tables 1 and 2**

<b>Share of Bulgarian supplies</b>			
	<b>Freq.</b>	<b>Percent</b>	<b>Cum.</b>
<b>No Bulgarian supplies</b>	22	18.97	18.97
<b>Minority Bulgarian supplies</b>	48	41.38	60.34
<b>Around half of the supplies</b>	15	12.93	73.28
<b>Majority Bulgarian supplies</b>	21	18.10	91.38
<b>Wholly Bulgarian supplies</b>	10	8.62	100.00
<b>Total</b>	116	100.00	

<b>Main resource suppliers</b>			
	<b>Freq.</b>	<b>Percent</b>	<b>Cum.</b>
<b>Bulgarian only</b>	21	17.95	17.95
<b>Foreign only</b>	43	36.75	54.70
<b>Bulgarian and foreign</b>	53	45.30	100.00
<b>Total</b>	117	100.00	

The second indicator for the links between foreign and domestic firms is the nature of the primary suppliers of the company (Table 2). Each company was asked to indicate the material which is most essential for its production. The primary suppliers were determined as the firms providing this material. The indicator can take three values: only Bulgarian, only foreign and both Bulgarian and foreign. The data shows again a marked preference for the use of foreign suppliers. Only 18% of the firms in the sample affirm to rely only on Bulgarian suppliers while 37% receive their principal material only from foreign firms. The statistics for the two indicators are quite consistent and both show little use of Bulgarian partners.

The aim of distinguishing between the two indicators is to account for the possibility that the bulk of the supplies for a foreign company comes mostly from Bulgarian producers but that the company prefers to contract out some vital supplies to foreign suppliers. The determinants influencing those two decisions are not necessarily the same as the degree of dependence on the supplier, and therefore the importance of the relation, is probably quite different. Understanding the driving factors is important from a FDI policy view as the linkages supposedly most beneficial for the host economy are those with the main resource suppliers. The foreign company will have much closer collaboration with these suppliers and hence, more opportunities for technological and managerial know-how spillovers will be created compared to transactions with suppliers of non-specific materials easily found on the market.

### ***3.3. Independent variables***

Two types of factors influencing the establishment of backward linkages have been identified in the previous section: those related to the characteristics of the investment project itself and those related to the perception of the institutional environment by the foreign companies.

#### **3.3.1. Investment related variables**

The motivation of the investment, the entry mode and the autonomy of the foreign subsidiary are the three features of the investment project that come out as determinants playing an important role in the development of relations with domestic partners. Several indicators for those characteristics were used for the needs of the present analysis.

##### Motivation of the investment

Following Dunning's typology, four categories of investments were distinguished: resource-seeking, market-seeking, efficiency seeking and strategic asset-seeking. The strategies were classified on the basis of the answers to the following question: Which were the main factors that have determined your company's decision to invest in Bulgaria? As discussed previously, market-seeking investors are expected to be most likely to establish local linkages as they have long-term prospects in the host country and their production is oriented to the local market. A second indicator for foreign investors' strategies which captured the current motivation of the investment was also used. A firm was considered domestic market-oriented if more than half of its production was realised on the Bulgarian market. Similarly to the entry strategy variable, domestic market-oriented companies should be more prone to establish backward linkages with local firms.

##### Entry mode

There are two main ways for a foreign investor to establish production facilities in a new country: greenfield investment and acquisition. The main difference between the two methods as far as the relations with local firms are concerned is that, in the case of acquisition, the investing company benefits from an already existing knowledge and participation in domestic networks. Thus, a variable indicating if the firm was established through greenfield investment or acquisition was included. In order to take into account the distinction made by Meyer and Estrin [2001] between the acquisition of a private company and the "brownfield" privatisation, a second variable taking three values (greenfield, privatisation, acquisition) was introduced. This allows to better capture the particularities of each entry mode especially if considering the importance of the privatisation process for CEE countries.

##### Autonomy of the subsidiary

As the objectives of foreign investments vary from one company to another, the forms these investments take are also various especially concerning the role of a particular subsidiary in the structures of the multinational company. However, what is interesting for the present study is one particular feature of the activities of the firm established in Bulgaria: its autonomy concerning the contracting of its supplies. If the central or regional headquarters are responsible for the contracting of the supplies, it seems rather unlikely that the company would prospect the domestic economy in search of convenient partners. Therefore, autonomous foreign subsidiaries are expected to have more interactions with local firms than those dependent on the mother company strategy.

### **3.3.2. Environment related variables**

In the case of transition economies, the institutional environment is particularly important for understanding the ways inter-firm transactions are handled, as institutional framework has been particularly unstable and weak contract enforcement has marked those economies. Three indicators of the perception of the environment by the European companies in Bulgaria are included in the regressions.

#### Efficiency of the courts

The first one concerns the perception of the efficiency of public courts and of their ability to enforce commercial contracts. If the courts are perceived as unable to guarantee the agreements between firms, the foreign company would choose very carefully its suppliers in order to avoid as much as possible potential conflicts. That could lead it to relying exclusively on well-known foreign partners for which much more is at stake than the sole materials for the Bulgarian operation of their client. The managers interviewed evaluated the capacity of the legal system to ensure respect of contracts and a dummy variable which captures a generally positive or generally negative opinion was constructed on the basis of this information.

#### Changes in regulations

Another aspect of the institutional context that can prove decisive for the choice of partners is the frequency of changes in the regulations affecting the production activities of the European investors. As continuing shifts in the legal framework may necessitate modifications in the agreements with suppliers, the need for reliable and ready-to-collaborate partners becomes stronger than in relatively stable regulatory environment. A dummy variable corresponds to the perception of foreign firms' managers of the changing legal environment that they qualified either as no or minor problem or as serious or major problem for their company.

#### Perception of domestic firms

The last element related to the environment is the perception of the Bulgarian firms as potential partners. Managers who consider that Bulgarian firms not respecting contracts is a serious problem for their companies are more likely to turn to foreign suppliers using the network of the mother company and to avoid relying on domestic partners seen as "risky". Thus, a dummy variable reflecting the opinion of the manager for unreliable Bulgarian firms being a serious problem for his company is also included.

### **3.4. Control variables**

Several other factors that could influence the strategies of the foreign subsidiaries are commonly mentioned in the literature. Therefore, two types of variables are integrated in order to control for some of the characteristics of the firm and for the accumulated knowledge about the local environment.

### **3.4.1. Firm characteristics**

Three elements that could influence the choice of suppliers are taken into account: the share of the foreign owner, company size and industry. The presence of a domestic partner can favour the choice of domestic suppliers as local firms have a better knowledge of potential domestic partners and can establish more easily relations with them (Javorcik [2004]). It should be noted that the ownership of the foreign subsidiaries in Bulgaria is extremely concentrated with about 73,5% of the sampled firms having more than 90% foreign ownership and of those 62,6% being wholly-owned. This concentration could be interpreted as a sign of a generalised reticence of European investors of working with Bulgarian firms despite the advantages that a local participation could procure in the context of an unstable and rapidly changing transition economy. Hence, a control variable indicating if the share of the foreign investor is superior to 90% was included.

The size of the foreign firm measured by the number employees could reveal important differences in the choices of the companies for two contradictory reasons. On the one hand, the volume of supplies could be an important determinant of the suppliers. Bigger companies will need important quantities of materials and thus, will have more facilities to work with foreign suppliers than smaller ones for which transport costs from abroad could become prohibitive. So, smaller companies can be disadvantaged on that point and thus be more prone to look for local suppliers. On the other hand, as Chen and al. [2004] point out, large firms can be more active than small firms in pursuing local linkages because of their larger capacity to absorb the risks involved in network integration and their ability to apply relational capital on a larger volume of exchanges. These considerations are reflected by a variable taking three values: micro or small company (less than 49 employees), medium (between 50 and 249) and big (over 250 employees).

### **3.4.2. Knowledge on host environment**

A second set of factors that potentially can direct the choice of suppliers is the knowledge on the host environment that the investing European company possesses. Therefore, the existence of previous links with Bulgaria, the possibility for progressive entry and the time spent in the country are taken into consideration. Similarly to the presence of Bulgarian owners, existence of previous contacts with the country or with locals can considerably help the integration of the foreign subsidiary particularly at the time of its establishment by providing specific information and contacts in the country.

The study also accounts for the practice of progressive entry on the local market of the foreign company. Several analyses (Horstmann, Markusen [1996]; Barkema, Bell, Pennings, [1996]) have underlined that, in some cases, progressive entry may be a better strategy than directly starting manufacturing activities. Investors that have begun with sales representations have more time to familiarise with the local conditions and market and therefore, to identify and gather information about potential domestic partners.<sup>7</sup> Following that reasoning, the variable “Progressive entry” indicates if the period between the registration of the company in Bulgaria and the start of the production activities is more than one year.

The third control variable here is the duration of the operations of the company in Bulgaria. As Chen and al. [2004] affirm that “cumulative learning and interactions in foreign environments entail that operations in universal foreign markets become increasingly

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<sup>7</sup> Several interviewed companies started with distributor contracts and/or trade representation before deeming the market promising enough to engage in production activities in Bulgaria.

embedded in the local networks over time.” The same observation is present in the WIR [2006]. Another reason for a positive correlation between the duration of the operations and the preference for local suppliers is that with the stabilisation of the macroeconomic environment and institutional reforms, firms’ histories lengthened and more possibilities for cooperation with domestic companies opened.

#### **IV. Empirical results**

In the previous sections of this paper several factors potentially influencing European investors in Bulgaria in their choice of suppliers were identified and discussed. The present section is devoted to the empirical verification of the propositions advanced so far. The determinants of the share of the Bulgarian supplies are treated before turning to the selection of the main resource suppliers.

##### ***4.1. Share of Bulgarian suppliers***

To test the propositions advanced in the second part of the paper an ordered logistic regression model was used with dependent variable the share of Bulgarian supplies in the total of the materials needed for the production of the foreign subsidiaries. Let’s stress again that this indicator includes all the production related supplies of the company and thus, may cover a large variety of relations with partners. The results of the regressions are reported in Table 3. Controls for the industry sector were added to each of them but did not modify the conclusions and therefore are not presented.

Starting with the investment project related variables, only the entry mode remains highly significant and robust in all regressions. Hence, the results give strong support to proposition 2 but do not provide empirical verification for propositions 1 and 4. The regressions were also run with a three-scale entry mode variable distinguishing between privatisation and private company acquisition. Both types of entry mode were positive and significant which implies that the important difference is between greenfields and acquisitions. This result confirms the proposition that ready access to local networks and already established partners in the case of acquisitions increases the use of domestic suppliers compared to greenfield subsidiaries for which the transaction costs of searching and contracting with new partners can discourage foreign investors of working with local partners. Furthermore, as the dependent variable probably takes into account the procurement of many standardised and/or secondary materials, the empirical study suggests that for a large part of their supplies, acquisition investments stick to the existing relations with domestic firms while greenfield use investments the mother company procurement network.

Let’s now turn to the variables concerning the managers’ perception of the business environment in Bulgaria. The one which influences the choice of suppliers is the confidence in the capacity of the legal system to enforce agreements with commercial partners. Efficient courts encourage contracting with local firms as subsidiaries’ managers believe that agreements can be easily enforced. This result is consistent with previous research (Johnson, McMillan, Woodruff [2002]) that establish in several CEE countries a positive correlation between firms’ readiness to start relations with new unknown suppliers and their evaluation of courts as efficient. It could be speculated that the positive effect of efficient legal system on the creation of inter-firm linkages is even stronger for newly established foreign companies with an important number of potential but unfamiliar partners.

**Table 3: Dependent variable Share of Bulgarian suppliers**

	<b>Model 1</b>	<b>Model 2</b>	<b>Model 3</b>
Domestic market oriented	-0.9427 (0.7418)	-1.3910* (0.7707)	-1.0403 (0.8418)
Acquisition	2.0908*** (0.7849)	1.9567*** (0.7236)	2.9146*** (0.9138)
Autonomy	1.4506** (0.6640)	0.9808 (0.6841)	0.6943 (0.7084)
Efficient court	1.0913* (0.6506)	1.5105** (0.6768)	1.7432** (0.7271)
Existing links	-0.4458 (0.8257)		-0.6881 (0.8518)
Years in Bulgaria	-0.0597 (0.0421)		-0.0708 (0.0440)
Progressive entry	0.3016 (0.7088)		0.5003 (0.7640)
Medium firm		0.6416 (0.7543)	0.4603 (0.8278)
Big firm		-1.0764 (0.9286)	-1.3705 (0.9758)
Full foreign ownership		-0.5910 (0.7548)	-0.2687 (0.7637)
Pseudo R-Square	0.1397	0.1844	0.2063
chi2	16.4277	22.8482	23.2874
p	0.0215	0.0018	0.0097

\*\*\* 1% significance level, \*\* 5% significance level, \* 10% significance level

#### **4.2. Main resource suppliers**

The results concerning the determinants of the choice of the main resource suppliers are somewhat different. Let's remind that the main resource suppliers are those providing the foreign company with the most important material necessary for its production activities. The number of suppliers of this resource is most often small. The estimation was made with a multinomial logistic regression, the base outcome being "only foreign suppliers". The results of two regression models including different environment-related factors are presented in tables 4 and 5. Again controls for the industry sector were added to each of them as well as a variable accounting for a restricted choice of partners because of a limited offer of the main resource on the market. Both controls were insignificant and did not modify the results.

The central factor influencing the choice of main resource suppliers is the degree of autonomy of the Bulgarian operations of the foreign company on that matter. The independence of the subsidiary increases the chance of both having some Bulgarian main resource suppliers and of completely relying on local firms for that material. The capacity of the local managers to choose their partners seems an essential condition for the foreign company to work with domestic firms on this important issue. When considering the possibility of completely turning to local suppliers, a second aspect of the investment project also enters into play. Similarly to the share of Bulgarian suppliers in total supplies, the ready access to information

and local networks through acquisition raises the probability of relying entirely on domestic suppliers.

Managers' perception of court efficiency does not seem to influence the preference for the suppliers of the main resource. This observation is not surprising considering that the linkages of interest concern the most important relations for the firm. Hence, it is understandable that the foreign company does not count so much on the legal system to enforce agreements with those partners with which continuing close collaboration may be necessary in order to ensure a smooth production process but puts more efforts in the choice of a reliable supplier. The empirical results give support to this affirmation showing that the perception of Bulgarian firms as unreliable decreases the chance of completely relying on domestic suppliers for the foreign company's main resource.

A second important point is the instability of the legal framework that puts some additional strain on relations with commercial partners. Frequently changing regulations of the production activity may entail frequent adjustments of the agreements with suppliers, in particular with those providing specific materials. Foreign suppliers may accept to adapt agreements more readily if they have higher stakes and reputation concerns in the good working of the relationship than local partners. This is the case, for example, when the foreign supplier has long-term benefits from collaborating with the company in several countries. Thus, the changing context motivates contracting with well known suppliers of the mother company and decreases the chances of entirely counting on domestic partners.

	Model 1		Model 2		Model 3	
	Bulgarian only	Bulgarian and foreign	Bulgarian only	Bulgarian and foreign	Bulgarian only	Bulgarian and foreign
Domestic market oriented	0.5814 (0.8664)	-0.2479 (0.6986)	-1.0785 (0.9821)	-0.6361 (0.6516)	-0.0731 (1.1368)	-0.5580 (0.8539)
Acquisition	2.2999** (0.9316)	0.7150 (0.6347)	2.1637** (0.9122)	0.4146 (0.5536)	2.4062** (1.1132)	0.4403 (0.6933)
Autonomy	2.4761*** (0.8860)	2.0279*** (0.7167)	2.4560*** (0.9103)	1.7889** (0.7143)	3.1271*** (1.1147)	2.4237*** (0.9027)
Frequent regulatory changes	-1.5046* (0.8328)	-0.1791 (0.5618)	-1.6248** (0.8168)	-0.5092 (0.5209)	-2.2463** (1.0235)	-0.4844 (0.6185)
Existing links	-0.3360 (0.9399)	0.3895 (0.6448)			-0.3549 (1.0854)	0.7236 (0.6978)
Years in Bulgaria	-0.0752 (0.0647)	-0.0449 (0.0451)			-0.0912 (0.0829)	-0.0347 (0.0541)
Progressive entry	-0.3805 (0.9256)	0.4180 (0.5886)			-1.6120 (1.1993)	0.0354 (0.6264)
Medium firm			-1.8821* (0.9861)	-0.5550 (0.6654)	-2.1132** (1.0625)	-0.8959 (0.7784)
Big firm			-1.4688 (1.0997)	-0.4270 (0.7165)	-1.9086 (1.2779)	-0.4871 (0.8043)
Full foreign ownership			-0.0621 (0.8479)	-0.3239 (0.6054)	-0.5297 (1.0426)	-0.3354 (0.8035)
Pseudo R-Square	0.1656		0.1592		0.2364	
chi2	27.6712		28.1764		36.7717	
p	0.0157		0.0135		0.0125	

\*\*\* 1% significance level, \*\* 5% significance level, \* 10% significance level

**Table 5: Main resource supplier(s)**

	Model 1		Model 2		Model 3	
	Bulgarian only	Bulgarian and foreign	Bulgarian only	Bulgarian and foreign	Bulgarian only	Bulgarian and foreign
Domestic market oriented	1.0600 (0.9765)	0.4661 (0.7741)	-1.1496 (1.0271)	-0.4717 (0.6790)	0.0080 (1.3713)	-0.0364 (0.9039)
Acquisition	1.9799* (1.0418)	0.4886 (0.6782)	1.9894** (0.9416)	0.4517 (0.5613)	3.4433** (1.4211)	0.5571 (0.7213)
Autonomy	2.9697*** (1.0126)	2.5473*** (0.8470)	2.6253*** (0.9505)	1.8424** (0.7205)	3.8762*** (1.2925)	2.5717*** (0.9119)
Unreliability of Bulgarian partners	-1.5637* (0.8820)	-0.9786 (0.6283)	-1.7406** (0.8874)	-0.8513 (0.5533)	-4.3992*** (1.5783)	-1.5240** (0.7529)
Existing links	-1.0508 (1.0698)	0.1429 (0.7349)			-2.9746** (1.4748)	-0.0615 (0.8008)
Years in Bulgaria	-0.0685 (0.0624)	-0.0511 (0.0453)			-0.1476 (0.1062)	-0.0481 (0.0517)
Progressive entry	-0.2395 (0.9803)	0.2156 (0.6318)			-1.5006 (1.3194)	-0.0130 (0.6800)
Medium firm			-2.6126** (1.1253)	-0.6783 (0.6777)	-4.5941*** (1.6362)	-1.2185 (0.8255)
Big firm			-1.7493 (1.1431)	-0.8253 (0.7508)	-3.7388** (1.6598)	-1.2938 (0.8976)
Full foreign ownership			-0.1589 (0.8953)	-0.2055 (0.6475)	0.5806 (1.2919)	0.1328 (0.8326)
Pseudo R-Square	0.1871		0.1710		0.3023	
chi2	29.7770		29.2722		45.9357	
p	0.0082		0.0096		0.0008	

\*\*\* 1% significance level, \*\* 5% significance level, \* 10% significance level

## **V. Conclusion**

The central objective of this paper is to clarify the determinants of the selection of partners by the European manufacturing companies in Bulgaria. Once the decision to engage in FDI in Bulgaria is taken and the entry mode is determined, the manufacturing company needs supplies of various materials to realise its production. The ties created with local suppliers being an essential channel for positive spillovers to the host economy to materialise, the aim is to explain the extent of contracting with domestic suppliers. To do this, two types of factors are being taken into account, investment project related factors and environment related ones, drawing from existing FDI studies and from new institutional economics. Also, two indicators for backward linkages are used: the share of Bulgarian supplies in all materials and the main resource suppliers. The empirical results show clear differences in the factors determining the suppliers depending on the backward linkages indicator in consideration, in particular for the environment related aspects.

The way the foreign investor established its production facilities in Bulgaria is a major feature of the investment project which influences the likeliness of relying upon domestic suppliers. Acquisitions, be they privatisations or private company acquisitions, are much more likely to contract supplies to local partners in general and also to entirely procure their main resource from domestic firms, than greenfield investments. Thus, although greenfield may be seen as more desirable for host countries because they develop new economic activities, create new jobs and so on, the acquisitions are those that are more prone to establish backward linkages locally and therefore, to allow for the much wanted positive spillovers to realise.

Another important aspect orienting the main resource suppliers' choice seems to be the autonomy of the local branch of the foreign company. Previous studies (Javorcik [2004]) have suggested that the participation of a local partner in the ownership encourages working with domestic firms. However, the results of the present survey hint that what in fact makes foreign companies prefer domestic partners for important transactions is the degree of autonomy of the subsidiary on supply matters. In contrast, the motivation of the investment does not have any importance as far the selection of partners is concerned.

A contribution of the paper is the introduction of environment related variables reflecting the perception of foreign companies' managers on relevant topics such as the opinion on the efficiency of the legal system, the impact of the unstable institutional environment on firms' work and the view on potential domestic partners. As expected, high opinion of courts' capacity to enforce contracts is correlated with bigger part of the supplies coming from local producers. However, the perception of the legal system does not seem to influence the choice of main resource suppliers while both frequent legal changes and unreliable local partners deter the chance of a full reliance on domestic suppliers for essential materials.

In all their inter-firm interactions, firms try to solve differences without going to court (Macaulay [1963]). With crucial partners, collaborative attitude and finding informal solutions to problems is much more important than in transactions with secondary or standardised materials. These considerations help explaining why the perception of court efficiency has a positive influence over the choice of Bulgarian suppliers in general but none when the essential resource partnership is in view.

The results of the present study suggest that the determinants of the establishment of backward linkages vary depending on the type of relations considered: the interactions with suppliers as a whole or the contracting of essential materials. As the latter create more opportunities for close collaboration between the foreign investor and the domestic firms and hence for transmission of foreign know-how, FDI oriented policies should take into account the particular factors encouraging this type of linkages.

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