Suggested citation:
Surmanidze U. (2015). The impact of FDI and domestic business climate on local entrepreneurship in Transcaucasia: A case of Georgia in the years 2005-2015. *International Entrepreneurship Review* (previously published as *Przedsiębiorczość Międzynarodowa*), 1(2), 61-73.

The impact of FDI and domestic business climate on local entrepreneurship in Transcaucasia: A case of Georgia in the years 2005-2015

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Abstract:

The main objective of this paper is to examine the impact of FDI inflow on local entrepreneurship in Georgia. The secondary objective of the article is to determine what effects the business climate in the country has on the growth of local entrepreneurs. To verify the impact of foreign investments on domestic entrepreneurship, dynamics of active local enterprises in Georgia in the years 2005-2014 is used as a dependent variable. In regard with business climate, international business and credit rankings were selected to show how they are interrelated with foreign investments and how they affect domestic entrepreneurs. FDI has no significant effect on local entrepreneurship in Georgia, neither on their growth, nor on their fall, as Its share in the local economy is nominal. It is noteworthy, however, that inflow of foreign capital has positive impact on the country's business climate, promoting its image and rising international recognition. The favorable business climate can help many local enterprises, especially SMEs, to benefit from liberal environment, financial and tax incentives, less regulation and bureaucracy. This paper intends to enrich relatively poor literature about FDI effects on Transcaucasian countries, providing a clear understanding to what extend the local entrepreneurship are under the influence of FDI and general business climate in the country.

Keywords: FDI; entrepreneurship; business climate; Transcaucasia; Georgia
JEL codes: P45, F21

1. INTRODUCTION

Despite scarce resources of certain economies in particular (small market, limited natural resources, low-skilled labor force, etc) they are still capable to arouse an interest in international investors and attract foreign capital. Policies to attract foreign direct investments (FDI) have become very common among the governments, irrespective of the geographical location, development levels or industrial structure of their economies (Bellak et al 2008). FDI is one of the potential sources of economic growth for developing countries and great opportunity for them to catch up with developed states (Caves, 1996; Markusen & Venables, 1999; Javorcik, 2004). Investment process is primarily an initiative and decision of the investor, whereas a government of the receiving country is initiator and implementer of those reforms which influence the investor to make that decision. In most cases, both sides have strong interest in this form of cooperation, but they both have their risks. Investor may fail to gain expected income (both due to internal and external factors), while for the host state the concept of the risk is more complex. But still, in the era of globalization, most countries try not to hinder the entrance of foreign companies, including MNCs. They bring huge financial means, management know-how, technological progress and prestige for the country, but perspectives of local firms in these circumstances might be lusterless and unpromising, especially in developing countries where they are less powerful and "qualified" to face such competition due to lack of required assets. Many political, non-governmental and professional groups (unions) see this rivalry as an unfair reality which harms not only certain domestic businesses but the business environment and the whole economy as a result. Foreign companies set their rules on the market, attract skilled workers, gain bigger market shares and respectively, create some barriers in their industries, which put local entrepreneurship in a disadvantaged position. Some even say that domestic production is shrinking in this case and general investment climate of the country becomes less prospective. Foreign investors often repatriate their revenues to the country of their origin or to other countries, while local entrepreneurs reinvest the money in their businesses mostly in their countries, and the fierce competition which limits their production abilities can negatively impact state's economy.

In small and culturally distinctive countries, issues with FDI and globalization in general, are especially problematic as they affect not only the host economy but a socio-cultural side, carrying a serious threat to a cultural/national identity of the state. South Caucasian states (Azerbaijan, Armenia and Georgia) can be indubitably included in the list of such countries. These nations, distinct with their unique traditions and native customs, lived in closed borders (the Soviet Union) for many years, and long wished independence for them has started with wars, extreme poverty and many other problems. At the present times, despite some existing difficulties, these states are developing and growing economically. They attract foreign investments, try to promote local production and be actively involved in the global trade. This paper will examine what impact FDI and internal business environment has on the local entrepreneurship in Transcaucasia, focusing on Georgia, the country with the most open economy and successful (economic and political) reforms among Caucasus states according to various international organizations (World Bank; Transparency International, Heritage Foundation, S&P, Moody's, etc)

It seems that Georgia does not spare efforts to create attractive business environment and stimulate inflow of foreign capital. It has favorable and geopolitically important location, multilingual labor force, strong legislative support and tax benefits for entrepreneurs. Recently Georgia signed the Association Agreement with the European Union which considers its gradual integration with the EU. This includes an economic integration. The one of the most important sections of the agreement – DCFTA (The Deep and Comprehensive Free Trade Area) enables locally produced products and services to have free access to the markets of the European Union after the fulfilment of all obligations of the agreement. All these make investment climate in Georgia appealing for the investors, particularly for businessmen from such countries like Turkey, Azerbaijan, China, Netherlands, the UK, the USA. Main target sectors for the potential foreign investors are transport and communications, construction, energy, manufacturing, financial services, real estate and tourism. The country has the bilateral investment treaties with 33 countries and free trade agreements with 11 states. Local politicians and economists agree that country needs more foreign investments to boost economic growth, especially at this stage of acute currency devaluation (by more than 35% against US dollars), however, some experts state that it negatively affects the local entrepreneurship and additional pressure on domestic businessmen from foreign players will worsen their positions.

This paper is organized as follows: the literature review, which revises relationship between FDI and local entrepreneurship, is followed by description of materials and methods used for the research. Final sections of the paper are presented for analyzing results and drawing proper conclusions.

2. LITERATURE REVIEW

While much of the literature points out on the positive influence of FDI on receiving economy (Barry et al., 2003; Javorcik, 2004; Blanchard et al., 2009), there are still some evidences of its negative effects (Caves, 1996; Aitken & Harrison, 1999). Furthermore, the character of this impact largely depends on how foreign and local companies are related to each other, horizontally (intra) or vertically (inter) (Javorcik & Spatareanu, 2008) and whether foreigners' products are strategic substitutes or complements (Fudenberg & Tirole, 1984; Bulow et al., 1985).

FDI is linked to management know-how and technology transfer, hence, it is logical that the literature finds the dissemination of innovations on home firms mostly common positive spillover effect on the local entrepreneurship (Barrios et al., 2005; Ayyagari & Kosova, 2010). Javorcik (2004) and Haskel et al., (2007) claim that spreading of innovative ideas and technology brought by foreign firms will take place both across and within industries of the host economy. This type of positive spillover is called demonstration effects, or contagion-imitation effects (Kokko, 1992; Barry et al., 2003), implying that local companies will imitate foreign ones in technology, in developing of new products and business processes and in adapting their management styles/organizational structures. Moreover, export-oriented MNEs can serve as perfect instructors for domestic firms of how to enter overseas markets (Greenway et al., 2004), stimulating by this the growth of country exports and expansion of local businesses (Greenway et al., 2004; Christiansen & Ogutcu, 2002). FDIs bring new products and services to the receiving country and create with these new markets and business opportunities (horizontal effects). It can also spur local firms, by subcontracting or partnership with them for certain activities (vertical effects). Kim and Li (2012) single out two important aspects within supply-demand chain when foreign firms emerge in the country, these are backward and forward linkages. Backward linkages reflect the situation when foreign companies obtain raw materials for their products from local firms, whereas forward linkages occur when local firms buy goods and services from foreign-owned counterparts. Both sides benefit from such relationship and what is more important, the domestic economy benefits from it most of all.

Perhaps the most debated subject in the literature on relations of MNEs and local entrepreneurship is labor issues. While some scholars suggest that FDI has positive spillover effect on certain labor aspects, on labor mobility for instance (Caves, 1996; Fosfuri et al., 2001), most authors agree that impact of foreign groups on domestic businesses in terms of labor supply is negative. Local firms undergo so called “brain drain”, as their foreign competitors attract skilled workers by offering them much better employment conditions (salaries, development potential, etc) (Grossman 1984; De Backer & Sleuwaegen, 2003; De Backer 2011; Danakol et al., 2013). Furthermore, higher wages at MNEs can attract not only employees of domestic companies but also impulse some local entrepreneurs to give up their low-income business occupations in favor of employment at MNEs (Grossman 1984; De Backer & Sleuwaegen, 2003). Apart from crowding out local firms on the labor market, other negative effects include increased domestic market monopoly and setting high market entry barriers for local companies. Presence of well-established MNEs make industry extremely competitive which may lead small and less efficient local players to leave the market what eventually cause “market stealing” effects (Aitken & Harrison 1999; Djankov & Hoekman, 2000). Some academics argue that negative spillover effects are usually reported in countries with transition economies (Djankov & Hoekman, 2000; Konings, 2001; Sabirianova et al., 2005), whereas the opposite is observed in the middle income states (Doytch & Epperson, 2012). Based on the panel analysis of 104 countries, Kim and Li (2012) concluded that FDIs have positive impact on less developed countries with weak institutional support and particularly on new business creation there.

3. MATERIAL AND METHODS

Objective of this study is to understand effects of FDI on local enterprises in regard to the amount of their number. This paper also aims to understand how the business environment in the country influences the growth of local companies. As literature suggests, there are mixed results concerning the impact of FDI on domestic businesses, where in one scenario MNEs can impulse their growth and emergence, but in the other, they might create invincible barriers and force them to exit the market. Grossman (1984) states that FDI decreases the number of domestic entrepreneurs, whereas Jovanovic’s (1994) model of firm formation sees the positive linkage between the growth of foreign entrants and increasing numbers of local businesses.

In any case, changes in number of domestic firms in the economy are easily observable, therefore, the dynamics in number of active local enterprises in 2005-2014 years is employed to understand the case in Georgia and then to analyze the data for making proper conclusions. Distribution of FDI inflow across the economic sectors and the country's main macroeconomic indicators will be also presented in the article. International assessment of Georgia's business and economic reforms by prestigious worldwide organizations in the form of rankings and ratings are employed to have the whole picture about local business environment. Statistical information is collected from National Statistics Office of Georgia (Geostat) and working materials of National Bank of Georgia, as well as from data of various international organizations available at their websites.

4. FDI AND LOCAL ENTREPRENEURSHIP IN GEORGIA

After the implementation of reforms brought by the so-called "Rose Revolution" in 2003, Georgia started attracting more foreign capital, reaching its peak in 2007 with over 2 billion USD. This trend did not affect the number of local entrepreneurs until 2008, when first considerable change in the figure was observed. In 2008, the number has increased by 15%, however, it coincided with 22% fall of FDI inflow. While the inflow of foreign capital shrank to 658 million USD in 2009, the number of local enterprises continued stable growth in the same period. Similar tendency was noticeable in 2011-2013 years. In 2014 FDI inflow reached more than 1 758 million USD, 87% rise from 2013 (942 million USD), whereas the number of local enterprises in 2014 fell almost by 10 000 units. Despite such results, it will be misleading to argue that the growth in FDI flow caused the decline of local enterprises on the Georgian market and forced some domestic players to exit. Fluctuating dynamics is a cause of various complex issues that Georgian economy has undergone during these years, high unemployment and low wages for example stimulate many individuals to leave their jobs and start their own businesses, contributing therefore to growing number of local enterprises. Nepotism and cultural peculiarity towards hiring are also additional factors why so many Georgian professionals engage in starting own business rather than working for others, whereas recent Economic downturn (2013 – present), on the contrary reduced the number of local enterprises notably because of their bankruptcy or termination of the business activity.

Attraction of many foreign businesses was also conditioned by low taxes and legality of gambling business (including casinos) which is forbidden in Turkey and that is one of the main reasons why so many Turkish entrepreneurs come to Georgia. 2008-2013 years' stunted condition in respect to foreign investments is related both to Country's military conflict with Russia and global financial crisis, these important events could not leave macroeconomic parameters of Georgia unmarked.

Entrepreneurship in Georgia is very attractive occupation as many young individuals aspire to start their own businesses rather than to work for very low wages in an uncertain job market. Number of entrepreneurs is rising year by year in parallel with the improvement of the business environment in the country. Every government of the country state that business should be main creator of jobs, so it encourages the sector by creating liberal and business friendly climate. Tax incentive, less regulation and bureaucracy contributed the expansion of the local businesses, especially in the financial sector. Recently, business supporting state programs were developed to help small and medium enterprises to expand. These programs are focused mainly on manufacturing and export oriented sectors, as well as on

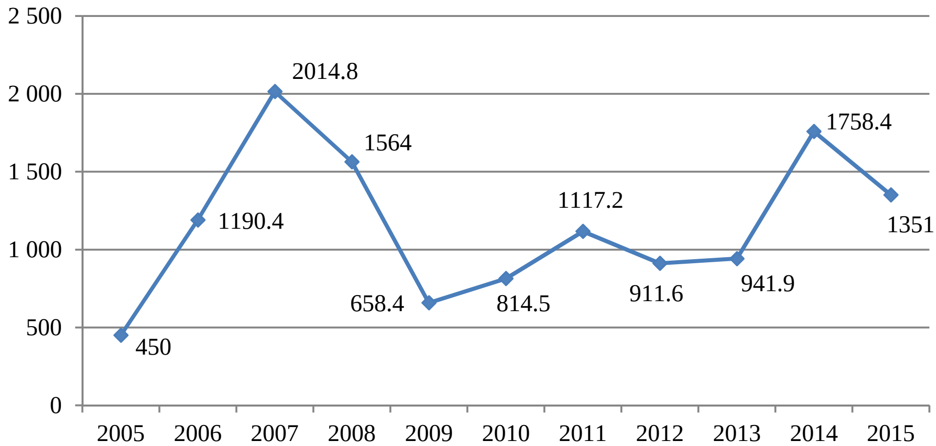

Figure 1. FDI Inflow into Georgia in the years 2005-2015 (in mln USD)
Source: National Statistics Office of Georgia.

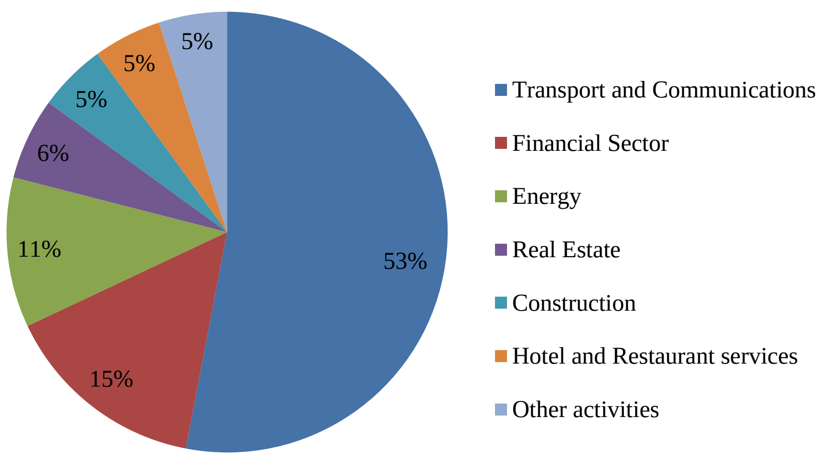

Figure 2. FDI Inflow into Georgia by Economic Activities in 2015
Source: National Statistics Office of Georgia.

tourism industries and even on start-ups. This made doing business in Georgia even more encouraged and less costly. Furthermore, association agreement with EU allows Georgian firms to access EU market without tariff barriers on almost every product. Some successful international business models were also introduced. From 2017, companies will be exempted from corporate income tax in case of its reinvestment in the business.

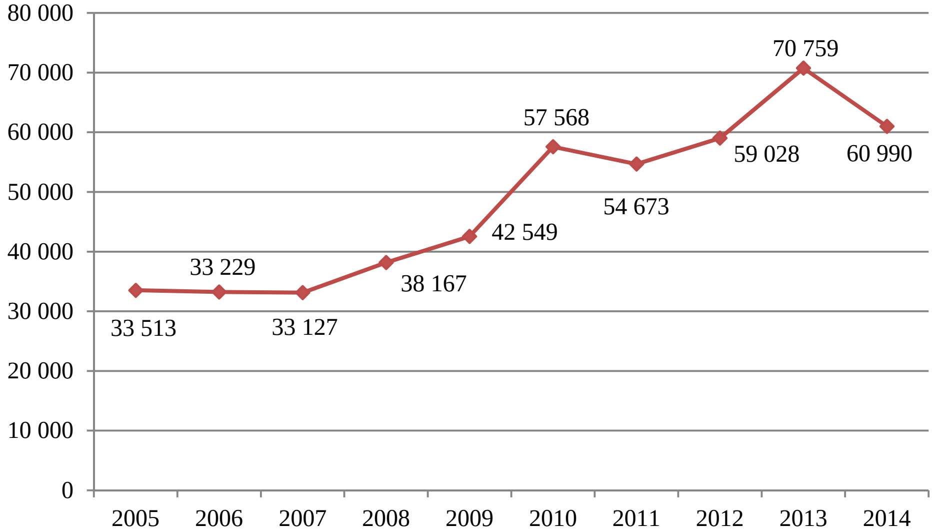

Figure 3. Number of Active Local Enterprises in Georgia in the 2005-2014
Source: National Statistics Office of Georgia.

5. BUSINESS CLIMATE IN GEORGIA

As the small country with scarce natural resources and limited domestic market, Georgia tries to attract FDIs and stimulate exports by various fiscal and financial incentives. It has investor friendly business environment with low taxes and liberal trade policy. The country also tries to use its location as an important asset to stand out from neighboring states. It is the main transit country for cargoes from Turkey, Kazakhstan and Azerbaijan. Apart from institutional support, the government spends actively in infrastructure to contribute in making Georgia regional economic and business hub. Small internal market leaves no choice for the country but to open its borders, limit trade barriers and exempt both export oriented local and foreign entrepreneurs from taxes. Both export and re-export are exempted from customs duty and value added tax. Import restrictions are extremely rare. Foreign investors have all rights to repatriate their profit and dividends back to their countries and there are no limits in hiring foreign citizens.

Economic slowdown in recent years are conditioned mainly by economic and noneconomic problems in Georgia's main trading partners (Turkey, Azerbaijan, Ukraine and Russia) and depreciation of the national currency decreasing foreign trade and aggregate demand as a result. Sharp decline in population also has its negative effects on the overall economy. Despite the rise of emigration, remittances to Georgia continue to fall. Positive trends are observable in the number of new international hotel brands, foreign tourists and business visitors.

Table 1. Key economic indicators in Georgia in the years 2010-2015

Georgia	2010	2011	2012	2013	2014	2015
Area	69 700 km^2					
Population (Thousands)	4436.4	4469.2	4497.6	4483.8	4490.5	3713.7
GDP Nominal (Million, USD)	11 637	14 439	15 847	16 140	16 508	13 960
GDP per Capita (USD)	2623	3231	3523	3600	3676	3759
GDP Real Growth (%)	6.2	7.2	6.4	3.4	4.6	2.8
HDI	0.733	0.736	0.741	0.744	0.754	–
Annual Inflation Rate (%)	11.2	2.0	-1.4	2.4	2.0	4.9
Unemployment Rate (%)	16.3	15.1	15.0	14.6	12.4	12.0
Labor Force (Thousands)	1945	1959	2029	2003	1991	2022
Foreign Trade Turnover (Million USD)	6913	9259	10 413	10 433	11 463	9935
FDI Inflow (Million USD)	815	1117	912	942	1758	1351
Currency	GEL (Georgian Lari). 1 GEL=0.43 USD/0.38 EUR					

Source: National Statistics Office of Georgia; National Bank of Georgia; World Bank; IMF.

Favorable business climate and economic reforms have their recognition in various rankings provided by international organizations and rating agencies:

– Ease of Doing Business, by the World Bank Group combines 10 different indicators which sets the regulations supporting or preventing the business activity.
– Transparency International's Corruption Perceptions Index (CPI) illustrates the overall level of corruption (frequency and capacity) in government and public sector.
– Index of Economic Freedom (IEF), by the Heritage Foundation encompasses 10 main factors which determine the degree of economic freedom in nations.
– Global Competitiveness Index (GCI), by World Economic Forum measures states' macroeconomic stability, various aspects in business environment and their technological advancement.
– Fitch's, Standard & Poor's and Moody's ratings – ratings of biggest credit rating agencies which aim to provide potential investors with valuable information on country's economic, business and financial perspectives.

Promotion of the country in rankings was an echo of economic reforms started in 2004. Georgia has been remarkable in the region in terms of the progress in international rankings. In all major publications the country outruns all neighbor states, being in advantaged position for attracting investors. Ease of starting and doing business is one of the main factors for local and foreign businessmen for starting a business in Georgia. It is also worth to underline successful reforms in delivering various public services which are based on "one-window" principle, significantly simplifying investor's business occupation. The country was one of the most corrupted states in Europe in 1990s and early 2000s, whereas according to the International Finance Corporation (IFC) survey in 2015 businesses face "near-zero corruption" in the country. Both local and foreign investors relied on these rankings and felt less risk when investing in a small post-soviet state, and on the other, government used these standings for promoting the country as favorable business destination. It is also noteworthy that progress in credit ratings and international rankings is closely linked to macroeconomic parameters and in case of continuation of recent downturn rankings might change in the near future.

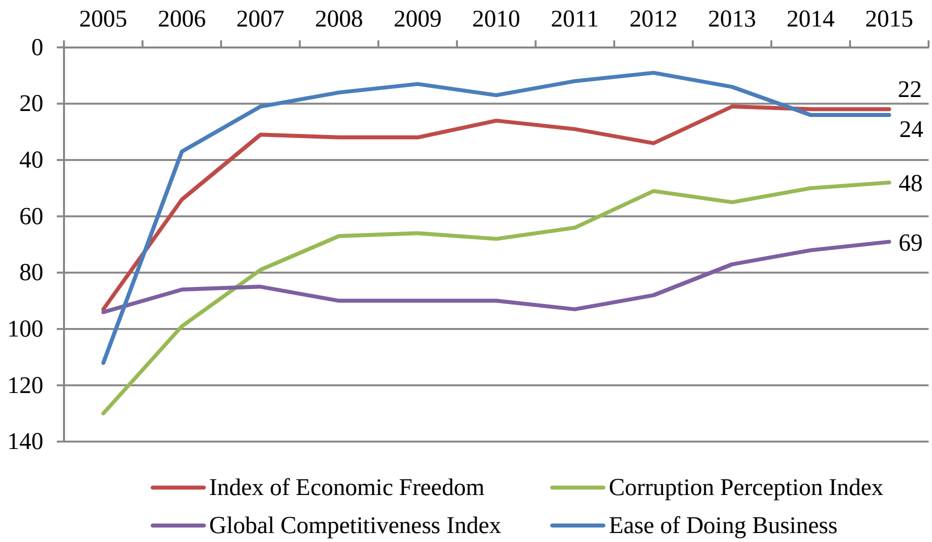

Figure 4. Positions of Georgia in four selected rankings in the years 2005-2015
Source: own study based on the data of the World Bank Group, the Transparency International, the Heritage Foundation and the World Economic Forum.

6. DISCUSSION OF RESULTS

Growth of FDI inflow is vitally important for the small economy in transition, especially for the post-conflict country. With international support and government's active intervention in the economy, FDI figures in Georgia started recovering. Restored confidence, economic incentives and association agreement with EU played important role in regaining interest in international investors. Number of local firms also has upward trend since 2008, but sharp decrease in 2014. This paper could not find any interrelation between the FDI trends and the number of local enterprises, as FDI has a small portion in the national economy and has no significant impact on the domestic entrepreneurship. There is no clear evidence that recent steady growth in number of enterprises or its dramatic fall in 2014 were somehow related to FDI inflow. FDI are distributed across such economic sectors (transport and communications, financial services, energy, real estate) which do not stand out by the concentration of the local entrepreneurs unlike trade, agriculture, manufacturing and construction, hence, there is a little intersection between these two groups. Products or services by foreign firms do not represent substitutes for domestic producers and this is one of the preconditions for their peaceful coexistence. Furthermore, it is noticeable how new generation of Georgian companies are engaging in untraditional (for Georgia) business activities utilizing novel management approaches and innovative business models. There is a reason to assume that such tendency is a result of contagion-imitation effects. As both indexes (FDI inflow and number of local enterprises) have similar growth trajectories, some might assume that it is a result of vertical effects of their interrelation (partnership, subcontracting). Although they cooperate in some occasions, the scale of these collaborations is insignificant, so if there are vertical effects at all, it is quite small. This applies to backward and forward linkages (Kim and Li's Supply-Demand Chain). The first linkage is extremely rare, whereas the latter is more observable but without notably affecting business environment and the local economy a fortiori. In regard to labor mobility issues, effects are uncertain as more than 50% from employed population in Georgia are self-employed, hence, that data are too thin to understand the trends in this respect.

Business friendly environment has clearly positive impact on domestic entrepreneurs. Easiness of starting business in Georgia, low taxes and attractive trade regimes impulse local citizens to engage in entrepreneurial activities. Rapid decline in number of domestic businesses in 2014 was conditioned by economic troubles caused by deprecation of the national currency and economic (and noneconomic) problems in main trading partners of the country (Turkey, Azerbaijan, Russia, Ukraine), causing shrink in both exports and imports. Many Georgian companies relying on markets of above mentioned countries and those with bank loans in US dollars found themselves in very difficult situation, some stating bankruptcy, cutting production and jobs, selling their assets etc. It is also worth mentioning the rise of excise tax and planned regulation of labor contracts as possible reason for the decline in the number. Despite this downturn in the last two years, many SMEs became beneficiaries of state supporting programs allowing them to co-finance bank credits, to use free consulting and technical support, and as minimum, to stay on the market without incurring in more debts. Business associations and individual entrepreneurs praised new reforms related to corporate income tax and VAT, prospects of EU market and free trade agreements with China and European Free Trade Association (Iceland, Liechtenstein, Norway and Switzerland). General liberal approach to entrepreneurship (as to main creator of jobs) in the country is easily visible by local and international communities, raising confidence and desire to support and be involved in the business activities.

7. CONCLUSIONS

Georgia creates environment where doing business is safe and less burdened, justifying its name as the leading reformer in the (Transcaucasian) region. Macroeconomic situation in the country is improving, so the central bank started decreasing discount rate gradually to make credits cheaper for commercial banks and its customers, and therefore, to encourage entrepreneurial activities and make those less costly. International recognition and high positions of Georgia in various rankings motivate the government to continue creating liberal economic climate and business-friendly legislation. As a result, both local and foreign firms, operating in the country, benefit from this attitude by expanding and diversifying their businesses, going global and generating high profits. However, it is essential to make the local economy more resilient to external shocks. Recent global economic slowdown and regional crisis in particular, made country's exports and remittances to fall, depreciating the national currency and making debt service for the local entrepreneurs more expensive. This hinders further investments and employment, and worsens economic situation in Georgia. Maintaining hard currency by gradual de-dollarization (more than 65% of total deposits and loans in commercial banks are in US dollars) is key for the healthy economy. Local businesses need also to diversify both their export products and export destinations, to be less dependent on neighboring countries which are not distinguished with economic and political stability.

There is no direct connection between the growth of FDI in Georgia and decline of domestic firms, and there is no connection in the opposite phenomenon too. Attracting FDI in industries heavily populated by local firms can be threatening for the domestic entrepreneurs, however, in the long-run, foreign investors may become their partners and leave many positive linkages. Furthermore, many local companies benefit from foreign investors by copying their management styles and business models, and by cooperating with them as their customers and rarely, as their suppliers. FDI has never represented significant portion of the country's GDP, hence, it cannot influence on local entrepreneurship solely. Other macroeconomic indicators should also be assessed with more depth to understand ongoing trends within local entrepreneurship issues, however, this is beyond the scope of this paper. Qualitative approaches in the form of in-depth interviews with local entrepreneurs would be very helpful as well, to understand Georgian entrepreneurs' perceptions on foreign companies and local business climate, and what's more important, actual effects of the latter two on the domestic businesses. It would allow to conduct more exploratory research rather than descriptive, offering more complete picture on the topic.

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