

# THE ROLE OF FOREIGN DIRECT INVESTMENT IN THE ECONOMY OF THE CZECH REPUBLIC

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## ABSTRACT

*Foreign direct investment play in a very open economy such as the Czech Republic a crucial role, including the involvement of small and medium-sized enterprises in the export. Foreign direct investment form the basis of industrial investments. Even small changes in the economic activities of large enterprises have a significant impact on the budgets of the state, regions and municipalities. It is not possible to identify the relationship of supranational companies and small and medium-sized enterprises as purely competitive in the national market. In addition to the economic effects, foreign direct investment play a crucial role in the development of human resources, the use of applied research and development and these businesses contribute to the image of the state and region. Large Enterprises are a key part of the economy of the Czech Republic and the EU.*

**JEL:** R11, R58

**KEYWORDS:** *Foreign Direct Investment, Economy, Investment*

## INTRODUCTION

Foreign direct investment (FDI) and related investment incentives have recently become increasingly pertinent topic of the professional and political representation. FDI inflow has a number of positive effects. The impact of investments on the labor market and employment is essential, particularly in the form of jobs created and the associated reduction in unemployment. Influence of supported FDI can also be perceived in the export growth, the transfer of know-how, the development of knowledge economy, and at the same time in their contribution to the growth of domestic product on national and regional scale. Contrarily, the negative aspects of investment incentives include the impairment of the competitive environment, which is created by investment incentives, and financial burden of investment incentives for public budgets. Proponents of investment incentives in the Czech Republic consider incentives as motivational tool for FDI inflows. Opponents of investment incentives, on the contrary, emphasize that there is no need to entice investors by system of incentives, that the Czech Republic is attractive for investors even without provided incentives. Supporters of incentives, by contrast, argue that neighboring countries have similar comparative advantages as the Czech Republic (in terms of qualifications, labor cost, location, taxation, etc.)

Following the above-mentioned, the aim of this article was set. It is to evaluate the development of FDI and investment incentives in the Czech Republic. To evaluate this matter, the data for investment aid implemented during the period 1998 to 2014 was used. The figures are collected by Czech National Bank and the agency CzechInvest which is responsible for providing investment support in the Czech Republic.

## 1 THEORETICAL BACKGROUND

While in the second half of the last century, the role of foreign investment in the economy was glorified, current professional attitude is a lot more reserved, for example Fallon, Cook (2010) pointed out that although foreign direct investments are generally considered to be very beneficial for development of economies, the results are not as unambiguous. Ties of foreign companies and the host country are very limited, management of the company is remote, decision-making autonomy is poor, regional firms play subordinate role, the production is often less sophisticated and distribution channels are subject to corporate strategy.

Driffield, Love (2007) drew attention to the fact that the impact on the host economy is dependent on the entry motivation of an investor. While foreign direct investment motivated by technological advantage of a host economy have no impact on productivity, in the case of investments motivated by sales lead to negative effects on the domestic economy (stolen market). The company buys an enterprise whose production subsequently substitutes.

Despite this criticism, most agree that foreign investment is very beneficial for the domestic economy. For example, already mentioned Driffield, Love (2007) state that foreign direct investments bring benefits to the host economy through participation in international market. Higher involvement in supplier-customer relations, subcontacts etc. can be named as direct consequences. Indirect effects are realized through the transfer of knowledge. Workforce belongs to a special category that represents the carrier for the spill-over effects.

Blomström, Kokko (1996) bring attention to the positive impact of FDI on the balance of payments. FDI inflows can be used to finance current account deficit. Very positive impact on the balance of payments can be perceived primarily in a "cost-seeking" investments, which are usually very export-oriented. Foreign direct investments therefore promote penetration in the markets of the parent companies, respectively markets where sister companies operate. Foreign direct investment in this respect, generate export potential of the region or state.

Positive impact on the labor market is often mentioned. Even here, however, the impact is not clear. Foreign direct investment, flowing into existing businesses, is often associated with the restructuring bringing the reduction in the number of employees. However, in the long run, it means preserving jobs that would probably, without restructuring and increase of labor productivity, disappear anyway. In connection with the labor market, the crowding out effect, stemming from restricting production of domestic competitors, can also be identified. This is particularly visible in "market-seeking" investment. Indirectly created jobs in supply companies have the fundamental effect on the labor market. Zamrazilova (2007) points out in this context that a new investor can either strengthen its ties with domestic suppliers, or on the contrary, interrupt the original cooperative ties and prefer imported components. In the case of cooperation with domestic suppliers the effects on employment can be positive; otherwise the interruption of the ties may result in job cuts.

Technology transfer is another positive effect on the host economy, contributing to greater productivity and competitiveness of the economy. Kokko (1992) refers to technology transfer as one of the key factors motivating to support FDI inflows. Similarly, Srholec, Plojhar (2004) state that multinational companies use modern technology to a greater extent. Multinationals can be described as instruments for the dissemination of technology. Srholec, Plojhar (2004) further distinguish technological transfer as direct and indirect. The direct transfer works within the multinational firm, specifically between headquarters and a branch in the host economy. In contrast, indirect technology transfer (technological spill-overs) means reducing the technological gap (difference in productivity) among foreign-owned enterprises and domestic enterprises. This transfer is based on the diffusion process, when workers changing employers

have the crucial role. Srholec, Plojhar (2004) added that the strongest technology transfer can be identified in the "market-seeking" investments in the form of advisory services, logistics and distribution networks. According to Dunning (1994) the intensity of the transfer is influenced by the nature of the position of foreign-owned enterprise in the production chain of a multinational corporation. For example, if it is only an assembly plant or autonomous production. Blomström, Sjöholm (1998) state that technology transfer is dependent on the nature of the host country. Preference is given to countries and regions investing in the knowledge economy. Following this finding, it seems logical that decisions of multinational companies on the localization of investment is influenced by the EU support, which is focused on economically lagging regions. Basile, Castellani, Zanfei (2008) state that the regions which received financial support through the Structural Funds, regions benefiting from the Cohesion Fund, were more attractive to foreign investors because of EU cohesion policy creates favorable conditions for investment in peripheral areas through funding education, infrastructure and research and development.

Carstensen, Toubal (2004) analyzed the factors that positively or negatively affect FDI inflows from OECD economies to Central and Eastern Europe. In this context, they identified specific factors for the transition economies. These factors include, for example, privatization opportunities that seem to be positive. Inappropriate methods of privatization, however, have exactly the opposite effect. Similarly, the uncertainty arising from the legal, political and economic environment have negative influence. These factors then determine the success of the transition countries in terms of attractiveness for foreign investors. In terms of low labor costs, especially Romania and Bulgaria are attractive. Positive effects (in these countries) are decreased by the slow transformation and uncertain economic environment (from the 90s).

Javorcik (2004) has set a goal to determine whether foreign direct investment will increase the productivity of domestic firms in Central European countries. The author looks at the productivity of domestic firms from the perspective of two types of spillover effects. Horizontal is described as spillover to potential customers. Vertical spillovers, on the contrary, go to potential suppliers of intermediates. The author mainly focuses on vertical spillovers and tries to identify its determinants. That, by analyzing the type of ownership of subsidiaries of multinational companies has a positive effect on the productivity of local suppliers. The author concludes that the results of the research show a positive spillover effect of FDI, which take place between branches of multinational companies and suppliers of intermediate goods (vertical spillover). However, the study does not suggest any effect of the horizontal spillover, i.e. to customers. The above described means that contact with multinationals has positive effect on the productivity of domestic firms. To be precise, the growth of presence of foreign firms by one percent produces a 15% increase in the output of each domestic supplier. This effect will be present only in the case of FDI with shared ownership, i.e. when the branch of a multinational company is owned by both domestic and foreign investors. If a multinational company is exclusively foreign-owned, the effect of increased productivity of domestic suppliers will not manifest.

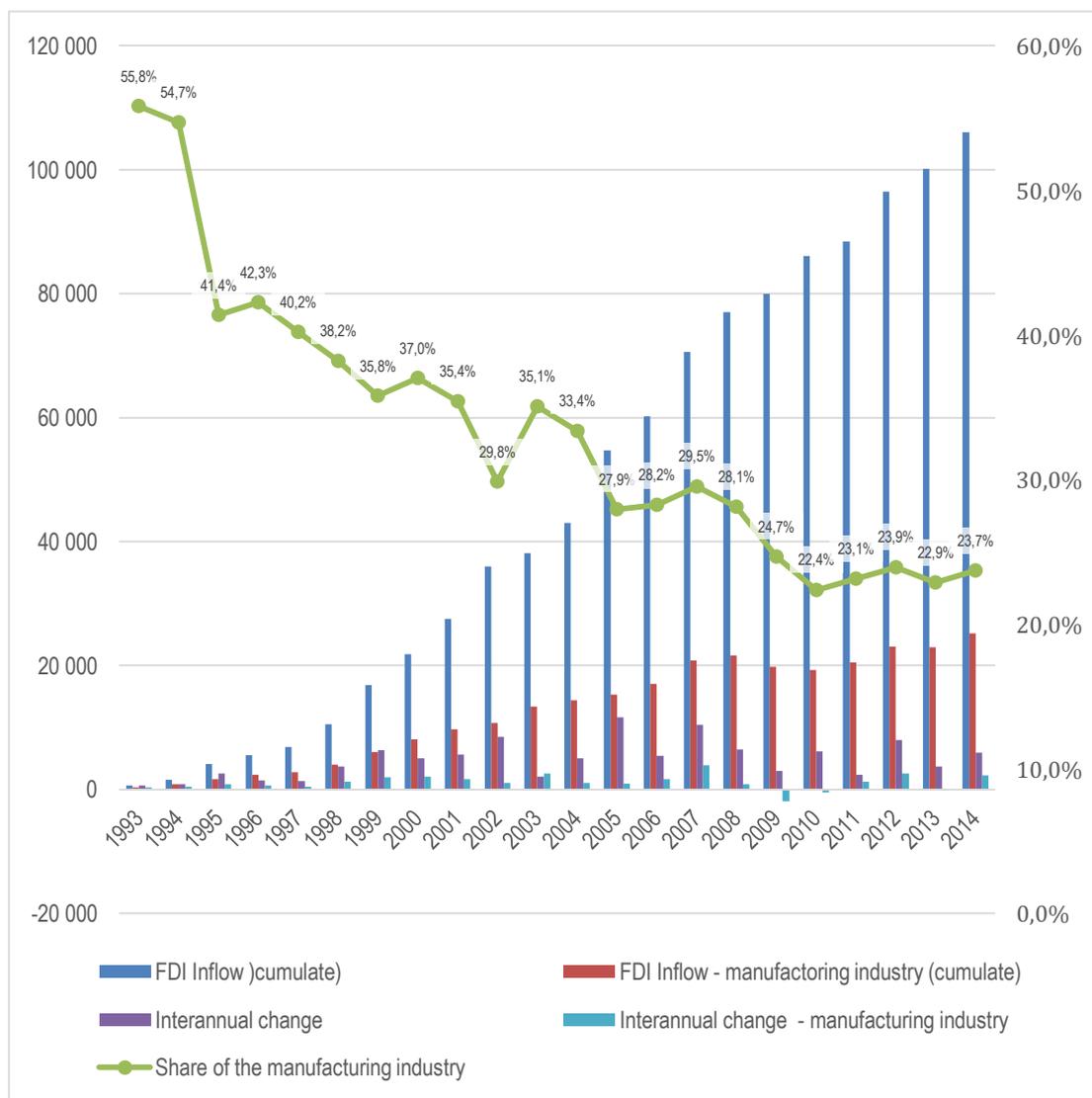
Based on carried out bibliography research, it can be stated that the prevailing opinion indicates foreign direct investment as a positive due to the economic objectives of host economies (economic growth, employment, export etc.). Therefore the investment incentives can be efficient for support of competitiveness.

## 2 FOREIGN DIRECT INVESTMENT AS A TOOL FOR TRANSFORMATION OF THE CZECH ECONOMY

Foreign direct investment is a key instrument in the transformation process of the Czech economy from a centrally planned to transitive and follow up post-transit stage. Currently, foreign direct investments contribute to the shift to standard market economy.

The share of manufacturing industry was more than 40% in the total sum of FDI immediately after the beginning of the transformation process (early 90s). It was gradually decreasing below 25% and investment services is dominated now. The reasons for this process was form of economic transformation (e.g. privatization of banks in “Czech way”) and partly the calculation methodology. Until 1997, Czech National Bank followed only investment capital.

**Graph 1 FDI inflow into the Czech Republic, 1993 - 2014 (in nominal value, cumulatively, in mil. USD)**



Source: Czech National Bank, calculations and processing by author

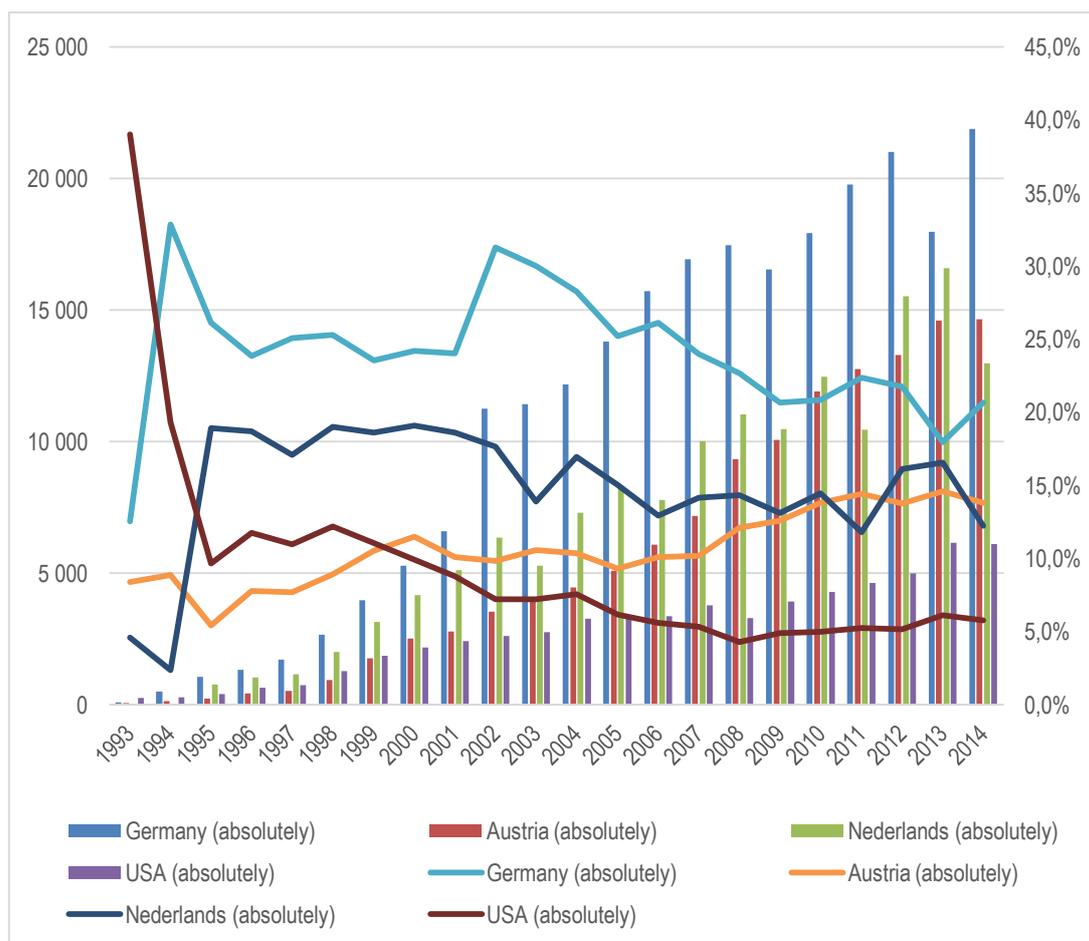
While in total accumulated value of FDI leads increases fluently, the accumulated value FDI in the industry is under the influence of economic development. Global economic crisis negative net FDI inflows caused in the years 2009 and 2010 in the Czech Republic.

Germany, Austria and the Netherlands are, in the long-term, the most important country of origin of the investors in the Czech Republic. The United States are the most important non-European countries. The development of these countries' shares are changing during the time.

Germany, in the long term the most important country of investors' origin, reach first position in 1994. However, its share is continuously decreasing (in long trend), Germany is the most important country.

Share of Dutch investments ranged from 17-19% in the period 1995-2002. It is clear declining share of the value of investments from the Netherlands in the period 2004 - 2011. The Netherlands is a popular platform for investments of other countries. Multinational investors use friendly regulatory environment (incl. a strong legal protection of investors investing abroad), and favorable tax conditions. The importance of protecting the investment base on bilateral agreement between the Czech Republic and the Netherlands fell down after entrance Czech Republic into the EU. The Czech Republic, as an EU member, is considered less risky. On the other hand, increase in the share of Dutch investment can be identified between 2012 and 2013. This increase is influenced by investment strategy of the companies owned by Czech owners which have relocated administrative address from the Czech Republic to Netherlands (e.g. invest company PPF). There is about 4 thousand of the firms owned by Czech owners in the Netherlands.

**Graph 2 FDI Inflow, countries of origin Germany, Austria, Netherlands, USA (in nominal value, in mil. USD, cumulated)**



**Source: Czech National Bank, calculations and processing by author**

United States were the most important country of origin of investors in the first year of the Czech Republic (1993). The share of US investment was in decline until 2008, the beginning of the economic crisis on the Czech Republic.

**Table 1 Inflow, countries of origin Germany, Austria, Netherlands, USA (in nominal value, in mil. USD, cumulated)**

	Absolutely					Relatively				
	1994	1999	2004	2009	2014	1994	1999	2004	2009	2014
Germany	500	3 965	12 173	16 537	21 881	32,8%	23,5%	28,3%	20,7%	20,6%
Austria	135	1 773	4 460	10 062	14 641	8,9%	10,5%	10,4%	12,6%	13,8%
Netherlands	36	3 134	7 293	10 477	12 971	2,4%	18,6%	16,9%	13,1%	12,2%
USA	294	1 863	3 258	3 916	6 113	19,3%	11,1%	7,6%	4,9%	5,8%

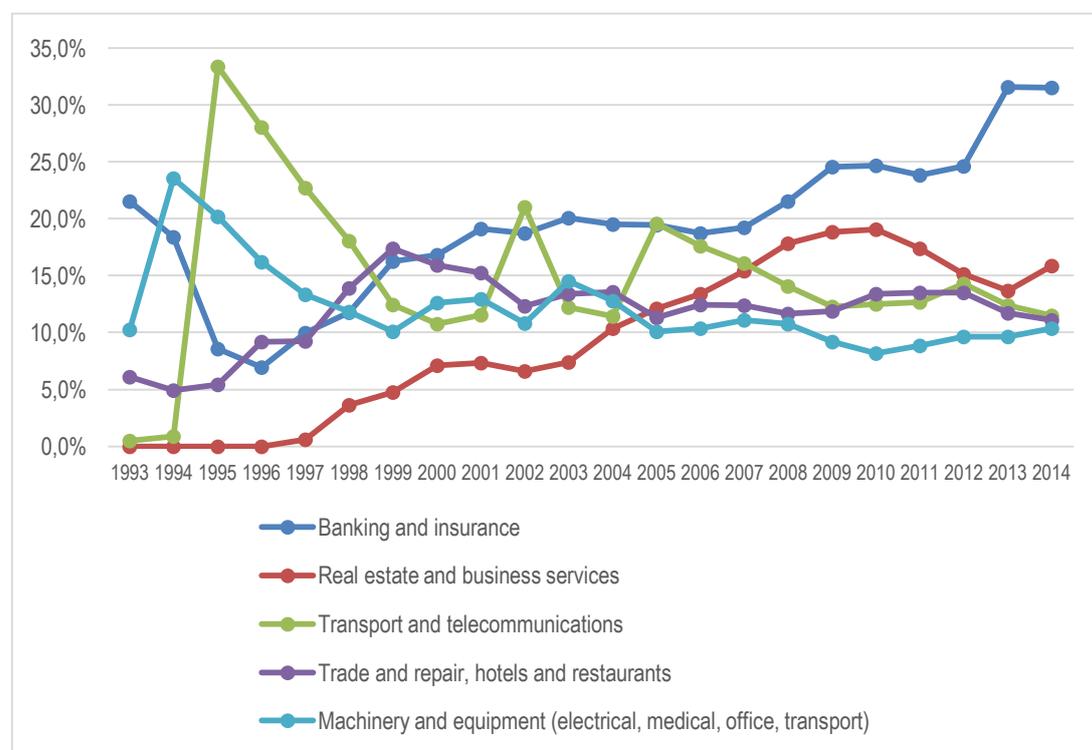
**Source: Czech National Bank, calculations and processing by author**

Austrian investors have been present in the Czech Republic significantly since 1993. Their share have been growing steadily since 1995. Direct foreign investments thus contribute to linking the economies of both countries.

German investors recorded in 2014 the share of the cumulated volume of direct foreign investments 20.6% (21.881 bn. USD). Austria is the second most important country of investor

origin (13.8%, 14,641 bn. USD), followed by the Netherlands and 12.2% (12,971 bn. USD), France 6.6% (6.992 bn. USD) and the USA 5.8% (6.113 bn. CZK).

**Graph 3 Inflow of FDI, the most important sectors (in nominal value, in bn. USD, cumulated)**

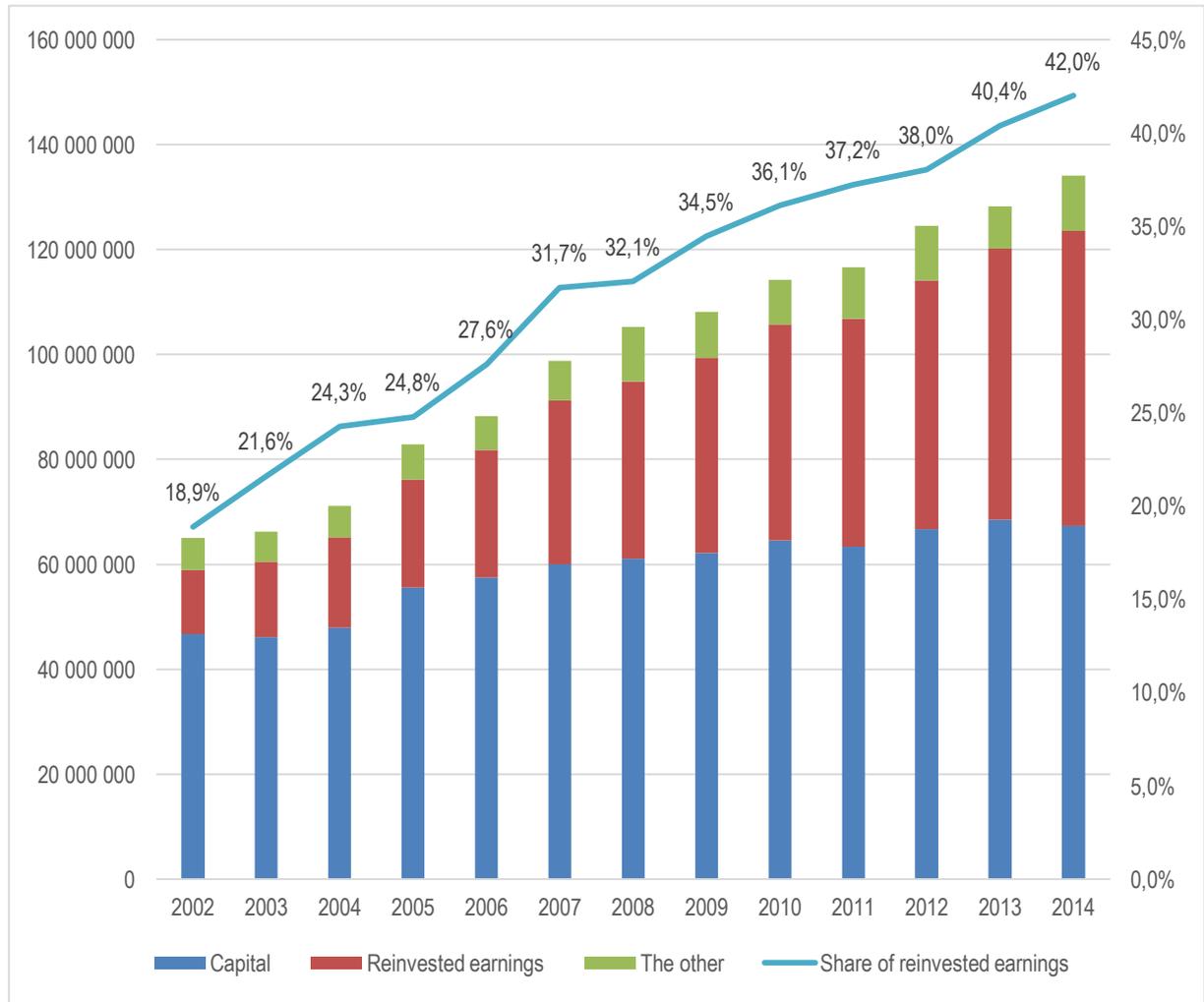


**Source: Czech National Bank, calculations and processing by author**

The most important branch of FDI inflows is banking and insurance. The share of industry grew gradually from 6.9% in 1996 to 31.5% in 2014. Investments in real estate and business services grew from 1996 until 2010 - currently consists of 15.8%. The third most important branch of transport and telecommunications. The significance of this field is very abrupt which is a result of the implementation of major investment and in 2014 the proportion was 11.5%. The development of investments is a clear orientation for investors market-seeking investment, which confirms the decreasing share of the manufacturing industry. This can be explained by the increasing purchasing power of the population and the transition economies into post-transition phase.

Czech National Bank has followed the structure of foreign direct investment according to the kind of investment that divide investment capital, reinvested earnings and other earnings since 1998. The share of reinvested earnings is very quickly growing since 2002 (from 18.9% to 42 % in 2014). Reinvested earnings has become the main source of foreign direct investment in the Czech Republic.

**Graph 4 Development of various types of foreign direct investment according to the state at 31.12.**



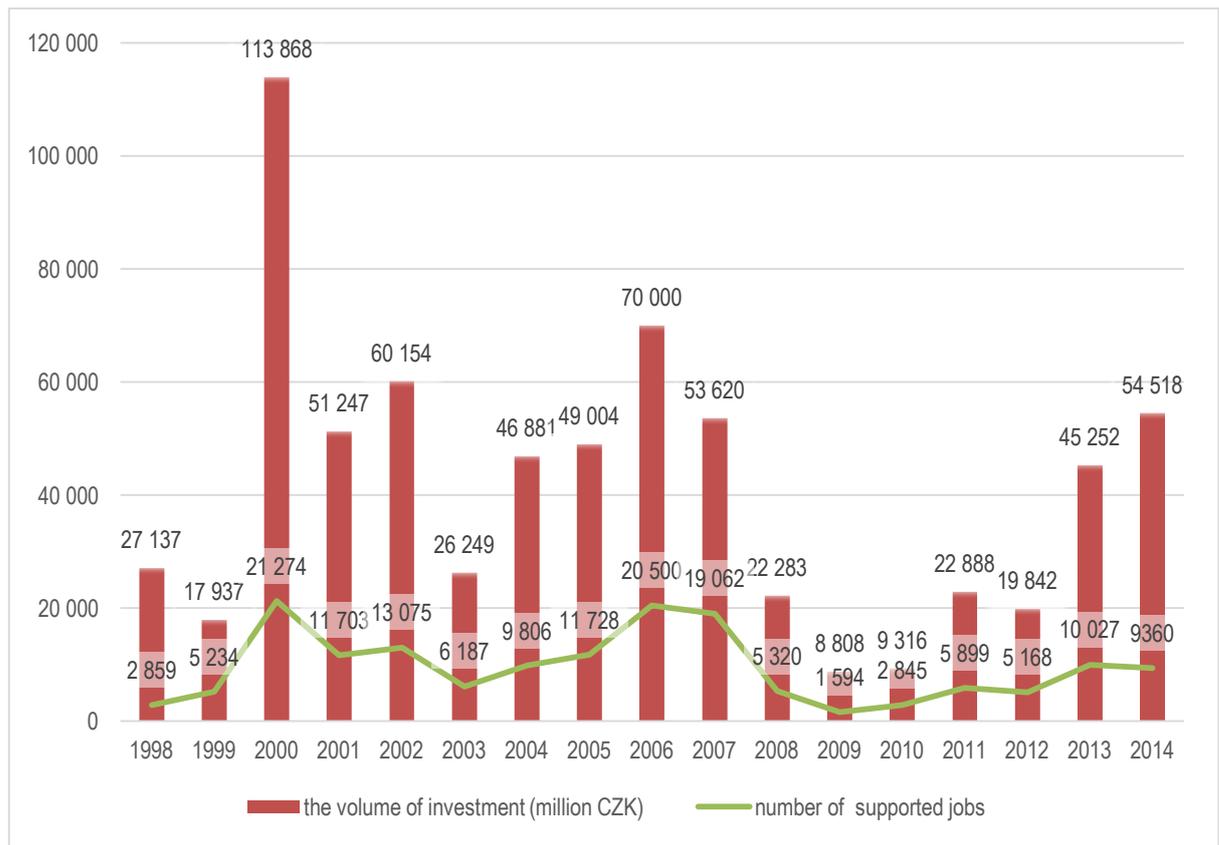
Source: Czech National Bank, calculations and processing by author

### 3 INVESTMENT INCENTIVES

This part introduces the development of investment support in the Czech Republic in the manufacturing industry. This type of investment support dominates in the Czech Republic. Only in recent years the aid in the Czech Republic is also aimed to support technology centers and strategic services. The analysis includes data about investment aid granted during the period 1998 to 2014. These figures are collected by CzechInvest, an agency promoting investments. Development of supported investments is a reflection of economic growth and development of investment support.

Investment incentives for manufacturing industry are granted in the Czech Republic since 1998. Corporate income tax abatement, financial support for creating new jobs and for training and re-training of newly hired employees in regions with above-average unemployment rate were established as investment incentives. Since 1998 to 2014 altogether 165,425 newly created jobs and 734,598 million CZK of investment in manufacturing industry were supported. The highest volume of investment was supported in 2000 and the highest number of jobs in 2006.

**Graph 5 Development of the volume of investment and number of jobs supported (1998 – 2014)**

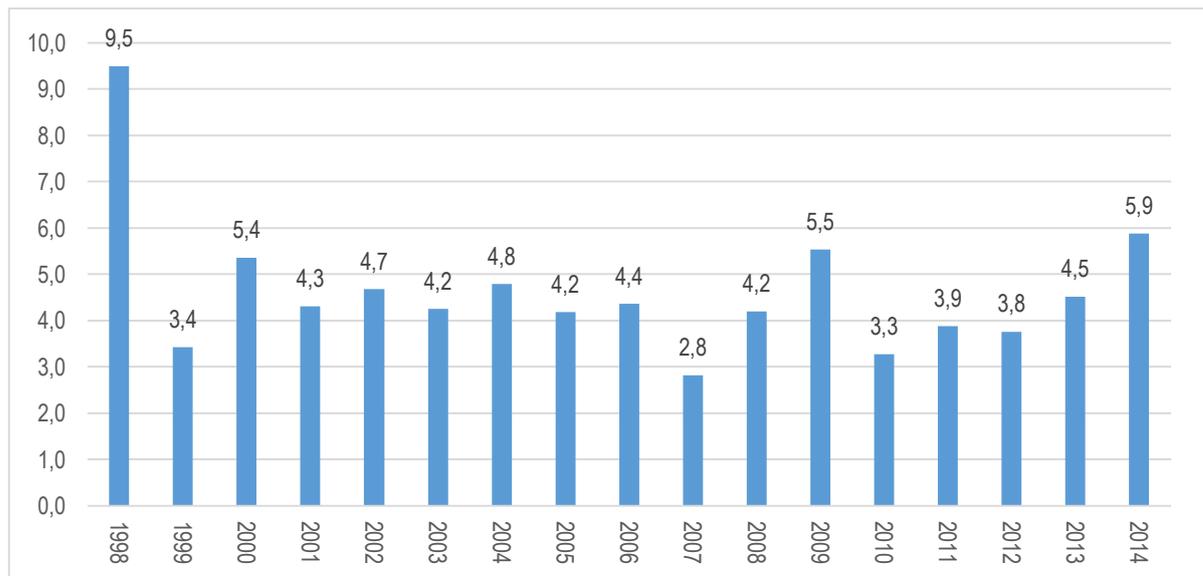


**Source: Authors according to data from CzechInvest**

The highest volume of investment incentives was recorded in 2000. 57 projects were submitted for support, in total volume of 113,868 million CZK of investment and 21,274 of newly created jobs. LG Philips Displays Czech Republic, Ltd. was the biggest investment plan, which assumed an investment of 22,526 million CZK and 3,250 of new jobs created. In this year two big projects of Panasonic company were supported. The first one of investment volume of 8,425 million CZK and 1,182 newly created jobs located in the Pardubický region. The second project was located in Plzeňský region with an investment volume of 2,602 million CZK and 1,440 newly created jobs.

In 2006 a total of 92 projects were submitted for support with a total investment volume of 105,591 million CZK (second largest size) and 24,254 new jobs created. That year the largest project ever was submitted for support in the manufacturing industry Hyundai Motor Manufacturing Czech Ltd. with the volume of investments of 34,429 million CZK and 3,514 newly created jobs. Another 8 projects had investment volume of more than 2 billion CZK. Average investment volume per project was 1,148 million CZK and 264 of newly created jobs.

**Graph 6 Volume of investment per one newly created job (1998 – 2014)**



**Source: Authors according to CzechInvest data**

In 2014, a record of total of 111 projects was submitted with a total investment volume of 54,511 million CZK and 9,270 newly created jobs. Out of these projects, only few were larger than 2 billion CZK, but another 8 projects exceeded 1 billion CZK of investment. On average, there was 491 million CZK of investment volume and 84 of newly created jobs. The volume of investment per job reached the second highest value ever, which is 5.9 million CZK.

## CONCLUSION

FDIs is traditional topic of economic and regional research. In particular, their efficiency for support of national economies and the associated positive and negative stimuli of foreign investment in the economy are debated. This is how current situation differs from the late 90s, when the foreign investment and thus investment incentives were perceived very positively.

Fallon, Cook (2010) indicate that the bonds of foreign companies and the host country are very limited, decision-making autonomy is weak, management in the host country is in a subordinate role, the production is often less sophisticated and conditions of sales are set by decision-making corporation center. Driffield, Love (2007) pointed out that the impact on the host economy depends on the motivation of entry of an investor, these being particularly technological advantage of the host economy or obtaining a sales market.

An important issue is the role of foreign investment in the labor market. Zamrazilova (2007) in this context states that the new investor can either strengthen his ties with domestic suppliers, or interrupt the original cooperative ties and prioritize components of imports. It determines the positive or negative impact on employment. The first model is rather typical for the Czech Republic, which contributes to rooting investor in the host economy.

Although positive perception of investment incentives is not so unequivocal, it is still possible to conclude that a positive outlook on foreign investment prevails in the literature. Foreign investments have a positive impact on the balance of payments (Blomström, Kokko, 1996). In addition to funds for actual investment, there are other effects associated with new sales opportunities in the domestic economy of the investor.

Positive impact on the technological development of the host economy is mentioned by Kokko (1992). Srholec, Plojhar (2004) draws attention to the direct and indirect technology transfer,

when the indirect transfer means reducing the technological gap between foreign-owned enterprises and domestic enterprises, which is based on a diffusion process induced by skilled employees changing their employer.

The transitive economies of Central and Eastern Europe represent specific environment for investors (Carstensen, Toubal, 2004). There, foreign investment accelerates the restructuring of transitive economies, strengthens innovative processes, improves labor productivity (see also Javorcik, 2004, specifically for the Czech Republic, see Djankov, Hoekman, 1999). For investors, these economies offer lower manufacturing costs including wage costs, while maintaining the benefits of culture (similar institutional environment) and geographic proximity (low additional transport costs). In addition, these economies may offer interesting investment opportunities arising from privatization Carstensen, Toubal (2004). **Most studies confirm the argument that FDI has a positive impact on the host economy.**

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The most important branch of FDI inflows is banking and insurance, real estate and business services, transport and telecommunications. The development of investments is a clear orientation for investors market-seeking investment which confirms the decreasing share of the manufacturing industry. This can be explained by the increasing purchasing power of the population and the transition economies into post-transitive phase. The share of manufacturing industry was more than 40% in the total sum of FDI immediately after the beginning of the transformation process (early 90s).

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**It was by analysis confirmed that the inflow of FDI is stable and very positive stimuli for the economy of the Czech Republic.**

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