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FDI in the Czech Republic: A Visegrád Comparison

By Septimiu Szabo

Summary

This brief provides an analysis of foreign direct investment (FDI) in the Czech Republic since the 1990s, looking at its evolution over time and its distribution across regions and economic sectors. As the ratio of the FDI stock to GDP has grown six-fold since 1993, FDI has become a major contributor to the country's development. Encouraged by record-high rates of profitability, many foreign investors have directed their businesses towards the Czech Republic, especially to Prague. The largest sources of FDI are the Netherlands and Germany, and the main sectors are financial services, wholesale and retail, and motor vehicle manufacturing.

As many investments reached maturity in the late 2000s, many foreign-controlled companies started to distribute a significant amount of dividends to their parent enterprises abroad. This outflow of dividends has particularly increased since the financial crisis, leading to an increasing GDP-GNI gap and a reduction in FDI inflows on the back of a low level of new capital acquisition. Nonetheless, even though a high proportion of profits have been repatriated, FDI has made a significant contribution to the domestic economy. The overall combination of new greenfield and brownfield investment, employment creation, taxes and social contributions, fiscal revenues, and domestic spillovers has had a much larger impact. Going forward, Czech authorities should encourage foreign investors to reinvest more of their earnings in the country by ensuring a viable business environment and a stable macroeconomic and political climate.

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Introduction

This brief analyses the foreign direct investment (FDI) in the Czech Republic since the 1990s. It looks at stocks and flows over time and the distribution across regions and economic sectors. It also describes how FDI developed in the Czech Republic, notably when comparing to other countries in the Visegrad group (V4), namely Hungary, Poland and Slovakia. Finally, it investigates the distribution of the FDI income and the contribution to the domestic economy. Annex I provides a glossary of the terms used in this paper and their brief definition.

FDI has played a major role in Central and Eastern Europe (CEE) in general and in the Czech Republic in particular. According to the Eurostat Foreign affiliates statistics (FATS), almost one-third of all jobs in the Czech Republic are provided by multinational corporations (MNCs), more than in any other CEE country. These MNCs can provide higher wages as they have around 25% higher costs per employee than the national average. On the same note, employees in MNCs have a 60% higher apparent labour productivity ⁽¹⁾, while the turnover per person is almost twice as high.

The Czech Republic has provided favourable conditions for attracting FDI. Through various incentives, authorities have encouraged both greenfield and brownfield investments. MNCs can get an income tax relief for up to 10 years, subsidies for creating employment and discounted prices for land. Grants and subsidies have been higher in regions with higher unemployment and investments in manufacturing and technological centres received additional benefits. Certain large investments obtained strategic investment status and, instead of tax relief, got a higher portion of incentives in cash grants. The income of MNCs is subject to a 19% corporate income tax and there is also a 15% withholding tax on dividends, where applicable ⁽²⁾. This withholding tax is the second-highest in CEE, after Poland which set the rate at 19%. Slovakia and Hungary, however, do not impose any dividend tax for MNCs from countries with whom they have an agreement. Furthermore, unlike its V4 peers which all imposed annual levies on bank assets varying from 0.2 to 0.55%, the Czech Republic does not have any sector-specific tax. Nevertheless, as mentioned in the latest Country Report issued by the European Commission (2018), important barriers to doing business remain and would need to be addressed in order to improve the business environment in the country. These refer mostly to

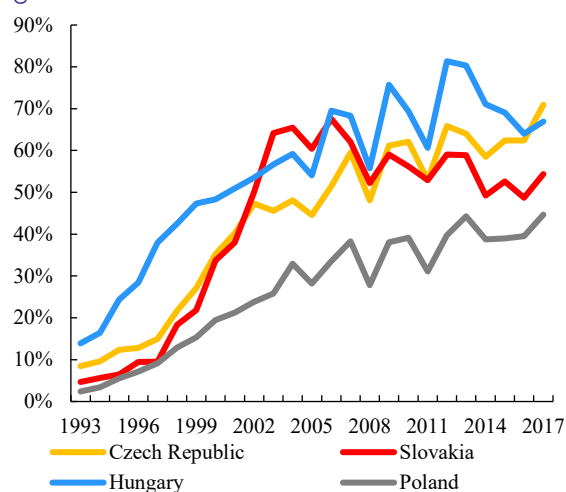
the long construction permit procedures, the complexity of the tax system and a significant administrative burden in some other areas.

The significant outflow of repatriated profits has become a topic of public debate in the Czech Republic. The country has provided one of the highest FDI rates of return in the EU ⁽³⁾ and the OECD ⁽⁴⁾ leading to significant incomes for MNCs. Since the EU accession two thirds of the total annual FDI income has been distributed as dividends. Consequently, in view of the increasing gap between the country's GDP and GNI, there has been an ongoing debate within the public opinion on the low rate of reinvested earnings. On the back of a low level of new capital acquisition, the reinvested earnings have been the main source of FDI inflows in the last decade. Nonetheless, as literature suggests, FDI is inherently profit-seeking and once investments reach maturity investors may be more interested in paying dividends. In addition, despite the high repatriation rate, FDI has brought significant benefits to the Czech economy in terms of employment, government revenues and domestic spillovers.

Evolution of FDI stock and flows

The inward FDI stock has grown significantly in the Czech Republic in the past 25 years. It increased from around 10% of GDP in early 1990s to over 60% in the 2010s. Among the V4 countries, the Czech Republic and Hungary have the highest FDI stocks as a share of GDP. Historically, Slovakia had a high growth but in the last decade it has been constantly decreasing. Hungary has also witnessed a downward trend since 2012 (Figure 1) ⁽⁵⁾.

Figure 1: Inward FDI stock as a share of GDP

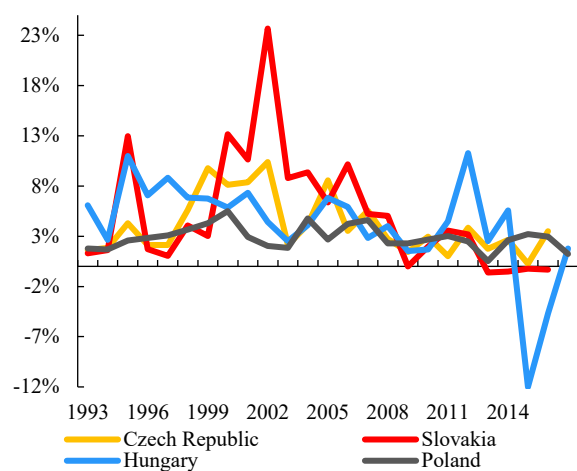


Source: UNCTAD statistics

Note: figures on Hungary exclude FDI generated by SPEs

FDI flows have dropped from 10% of GDP in early 2000s to below 5% of GDP. This decrease is partly explained by the fact that the inflows from privatisations dissipated as of 2006 ⁽⁶⁾ and most of the income has been distributed as dividends. Since the financial crisis, the FDI inflows have never represented more than 3% as a share of GDP, leading to a subdued increase of the stock. Nonetheless, as shown in Figure 2, the Czech Republic did not witness the large flow oscillation which has been prevalent in Slovakia (where inflows dropped from 24% of GDP in 2002 to 0% in 2009) or in Hungary ⁷. Instead, somewhat similarly to Poland, it has experienced a more gradual decrease.

Figure 2: **Inward annual FDI flows as a share of GDP**



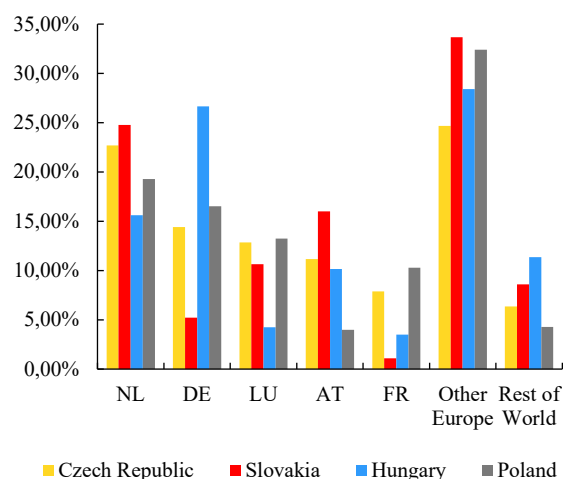
Source: UNCTAD statistics

Until recently, outward FDI flows were low. However, due to an increased overseas presence of Czech companies (in the Netherlands, Slovakia, Cyprus, Germany and Romania), outflows started to catch up recently, reaching between 0.5% and 2% as of share of GDP. According to UNCTAD, at 11% of GDP in 2017, the Czech Republic had the second highest outward stock of FDI among its peers, behind Hungary (20.5% of GDP) but ahead of Poland (5.9%), Slovakia (3.6%) or Romania (0.4%).

The Netherlands, Germany and Luxembourg are the main immediate partner countries in terms of FDI in Czech Republic. These countries also account for for half of the FDI stock in the V4 region. Nonetheless, the share of Dutch investments dropped from a third in the early 2000s to around one quarter. Germany has witnessed a similar trend, going from 25% to less than 15%, but its investment has slowly picked up in recent years. Luxembourg has had a significant growth in the 2010s becoming the third largest immediate investor, mostly because

Skoda Auto AS operates as a subsidiary of Volkswagen Finance Luxemburg S.A. Apart from Austria and France all other investors have a market share below 5%. Investment by MNCs from the EU has constantly stayed above 85% of all FDI in the country. Most extra-European investment has come from the USA, Japan and South Korea. Chinese and Russian FDI is below 1% of total stock. On the other hand, Hungary has a higher share of non-European FDI. Investments from V4 in the Czech Republic reach 5% (3% from Slovakia; 1.8% from Poland), lower than in Slovakia (16% out of which 10% are Czech investments), but much higher than in Hungary (0.8%) or in Poland (0.6%).

Figure 3: **Main FDI partner countries in 2016: shares in total inward FDI stocks**

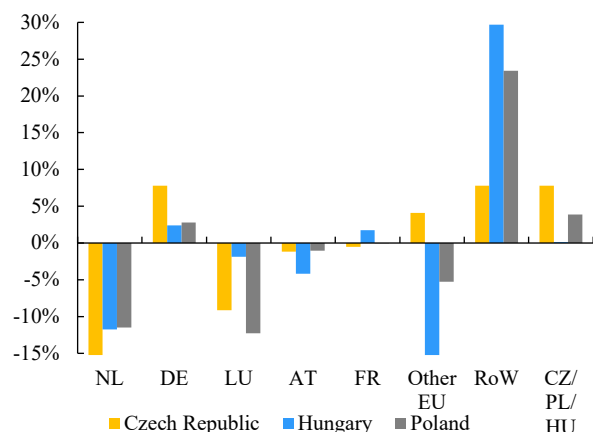


Source: statistics of the four central banks

Note: figures on Hungary exclude FDI generated by SPEs

Figures change when looking at the ultimate investor partner countries. Between 2013 and 2016 ⁽⁸⁾ the Netherlands and Luxembourg ⁽⁹⁾ were not among the top five investors in a chart topped by Germany with a 25% share, Austria with around 10%, the Czech Republic, via FDI round-tripping ⁽¹⁰⁾, France and the USA. As shown in Figure 4 this situation is not Czech-specific as the ultimate FDI coming from the Netherlands is low in all V4 countries. Data also suggests that non-EU FDI is significantly higher, channelled via some EU countries. Furthermore, FDI round-tripping seems to also be present in Poland. As mentioned in Annex I, the Netherlands and Luxembourg are among the major offshore financial centres that are responsible for the majority of FDI in special purpose entities (SPEs). Consequently, they are among the largest immediate partner countries in terms of both inward and outward FDI in most EU Member States.

Figure 4: **Evolution of the contribution to the total FDI stock of the main partner countries when switching from immediate to ultimate investors**

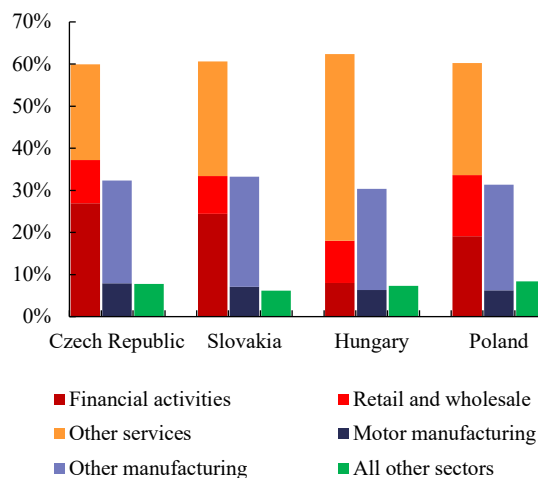


Source: OECD statistics. Note: Data from 2016 for the Czech Republic and Poland and from 2015 for Hungary. No public data is available for Slovakia.

Main economic activities

Motor vehicle manufacturing, financial services, wholesale and retail are the key sectors targeted by FDI in the Czech Republic. Foreign investment in services has increased over the last two decades, reaching 60% of the FDI stock (Figure 5). Financial and insurance services represent the largest share, growing from 15% in 2000 to 27% of the total stock in 2016 (and by a factor of 7), followed by wholesale and retail with around 10%. Motor vehicle manufacturing represents around 8% of the FDI stock and a quarter of all manufacturing investment. This level has stayed more or less constant over the years (it represented 6.3% of the total stock in 2000). In general, while the total stock of FDI in manufacturing has somewhat lowered from around 38% in 2000 to 32% in 2016, the increase of the share of financial services also relates to the reduction of the stock in wholesale and retail (from 15% to 10%) and in transportation, information and communication (from 11% to 7%). Most FDI in financial services originates from Austria, France and Belgium. Germany and the Netherlands are the largest investors in wholesale and retail. Over half of all FDI in motor vehicle manufacturing comes from Luxembourg, where Skoda Auto is registered. While countries like South Korea (car manufacturing) or Austria (financial services) focus mostly on a single economic sector, Germany and Netherlands have more diversified portfolios.

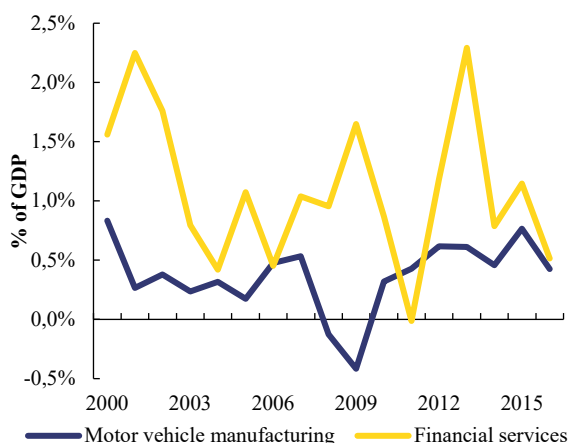
Figure 5: **Main economic sectors of FDI as a share of total inward FDI stock in 2016 (2015 for Slovakia)**



Source: statistics of the four central banks
Note: figures on Hungary exclude FDI generated by SPEs

While having a low contribution to the gross value added (GVA), financial services received significantly more FDI inflows. As shown in Figure 6, motor vehicle manufacturing FDI inflows have never represented more than 1% of the GDP and in most years the figure has been below 0.5%. By contrast, the FDI inflows in financial services represented up to 2% of GDP. The larger share of inflows can be partly explained by the fact that, until recently, the rate of return on investment in financial services has been constantly higher (at around 20%). Since 2013, however, the return on investment for motor vehicle manufacturing has significantly increased, moving from 11% to 23%, while the rate on financial service investments dropped from 20% to 11%. Looking at the contribution to the FDI stock and the contribution to the Gross Value Added (GVA) in 2015, it is noticeable that figures are similar for manufacturing (32.9% share in FDI stock and 26.8% share in GVA) and services (59.2% vs. 59.8%). There are, however, differences in the breakdown of services, especially regarding financial and insurance activities which contribute with only 4.3% to the GVA but with 27.3% to the FDI stock. By contrast, sectors such as transportation, education, health or public administration contribute with only 2% to the FDI stock but with more than 20% to the GVA. In general, after accession, the inflows of FDI have not significantly changed the structure of economy as the share of both manufacturing and services remained constant.

Figure 6: FDI inflows to the Czech Republic in motor vehicle manufacturing and in financial services



Source: Czech National Bank statistics

Both the motor vehicle manufacturing and the financial services industries became heavily foreign-owned in the last decades. According to the ECB, in the financial sector the share of total assets of foreign credit institutions was 91.7% in 2017, down from 96.8% in 2007, the largest figure among the country's peers (84.4% in Slovakia, 77.3% in Romania, 46.3% in Hungary and 45.2% in Poland) and one of the largest in the whole EU. The five largest credit institutions operating in the country (CSOB part of Belgian KBC Group; Ceska Sporitelna part of Austrian Erste Group; KB part of French Société Générale Group; UniCredit Bank part of Italian UniCredit Group; Raiffeisenbank part of Austrian Raiffeisen Group) account for 64.1% of the total assets, significantly higher than in Hungary (49.6%), Poland (47.5%) or Romania (59.4%) but lower than in Slovakia (74.5%). The three largest insurance companies operating in the Czech Republic are also foreign-owned, part of the Austrian Vienna Insurance Group, the Italian Assicurazioni Generali Group and the German Allianz Group. In the motor vehicle manufacturing industry more than 90% of the enterprises are foreign-controlled. There are three major car manufacturers (the German Volkswagen Group, the South Korean Hyundai Group and a French-Japanese joint venture of Toyota-PSA) and more than half of the world's 50 leading suppliers⁽¹¹⁾. The wholesale and retail sector is also heavily dominated by foreign-owned companies. In the retail market, for example, the top nine operators are all foreign-controlled (six from Germany and three from the

Austria, Netherlands and the UK), operating among themselves around 1,700 stores in the country.

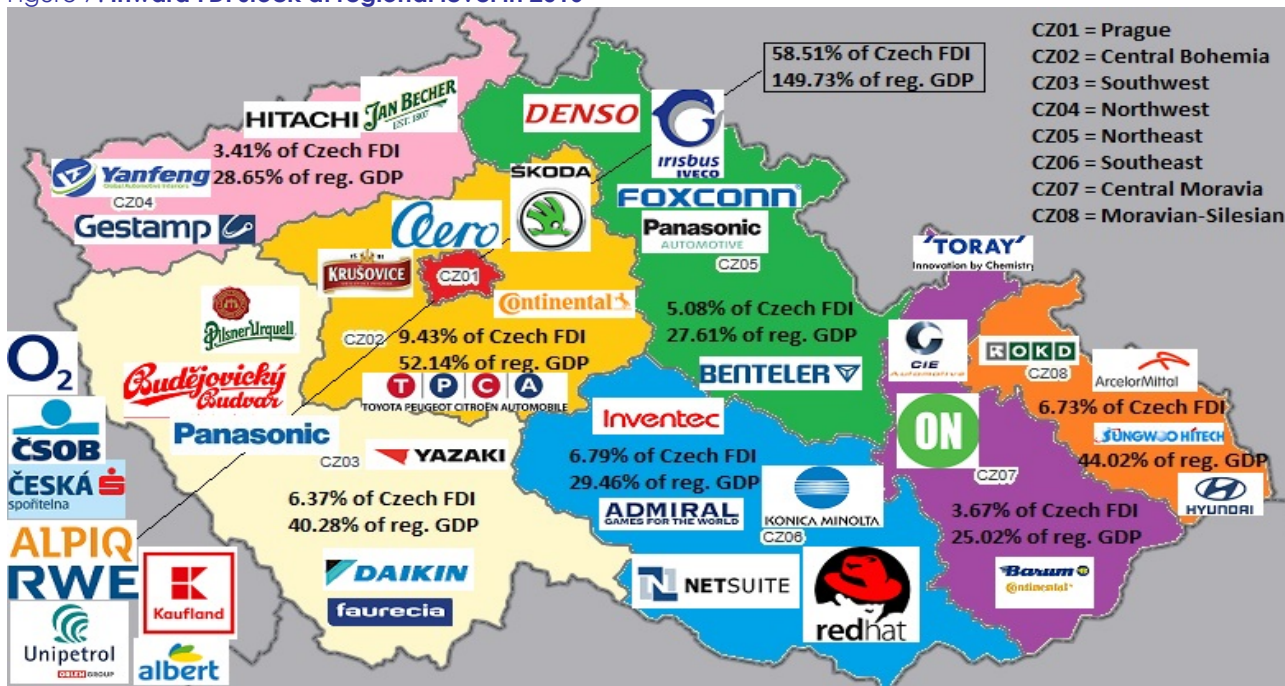
FDI at regional level in the Czech Republic

There are large regional differences in terms of inward FDI stocks. When looking at the eight NUTS-2 regions of the Czech Republic, it is noticeable that more than half of the whole FDI stock is concentrated in Prague, a region that in 2016 contributed with around 25% to the country's GDP. By comparison, Central Bohemia, the most FDI-intensive region outside Prague, has had a share of about 10-12% of the total stock. Central Moravia and the Northwest region account for around 3% of total stock each. When looking at the breakdown of the FDI stock, it is noticeable that there has been a visible increase of reinvested earnings in the past two decades. Nonetheless, apart from Prague and Central Bohemia, where reinvested earnings contributed to around a half of the regional FDI stock, in the other regions, less than 20% of the income was reinvested.

The dominance of Prague in terms of FDI is noticeable. Starting from a share of around 75% of regional GDP in 2000, it reached more than 150% in 2015 or a six-fold increase in absolute terms to 61 billion EUR⁽¹²⁾. Central Bohemia witnessed a more modest increase, moving from below 40% in 2000 to 60% in 2015 (12 billion EUR). The highest growth was observed in Moravia-Silesia where the ratio grew from 16% in 2000 to almost 50% in 2015. On the other hand, the Northwest region was the only region to witness a decrease, dropping from 33% in 2000 (3th highest) to 27% in 2015 (2nd lowest).

While almost all investment in services is located in Prague, foreign investment in manufacturing is located all around the country. Skoda and Toyota-PSA (TPCA) are headquartered in Central Bohemia while Hyundai operates in the Moravian-Silesian region, close to the KIA plant in Slovakia. Furthermore, the Taiwanese-controlled⁽¹³⁾ electronic manufacturer Foxconn, the second largest Czech exporter, is operating from the Northeast region. Similar situations are witnessed in Slovakia and Hungary where Bratislava and Budapest have received a significantly large amount of FDI and, to a lesser extent, in Poland.

Figure 7: Inward FDI stock at regional level in 2016



Source: own calculation based on Czech National Bank, EUROSTAT statistics.

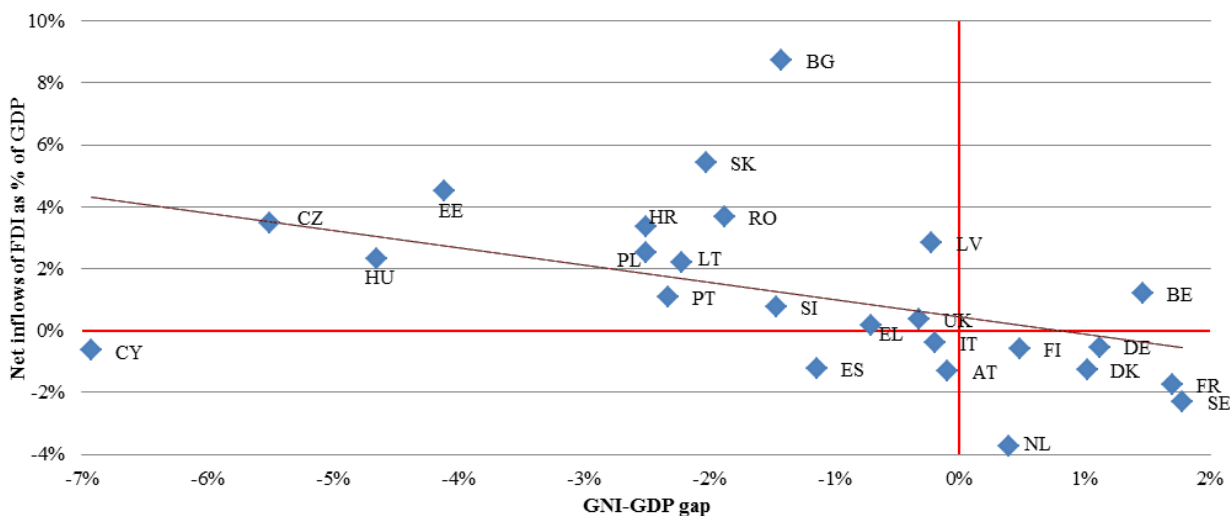
Note: Logos represent significant foreign-owned companies registered in the eight NUTS-2 regions.

FDI return on investment, reinvested earnings and repatriated profits

The Czech Republic has one of the largest gaps between GDP and GNI in the EU and the source of this discrepancy lies primarily in FDI-related phenomena. Unlike GDP, GNI excludes the income earned in the domestic economy by non-residents and adds the incomes earned abroad by Czech entities. Thus, in converging countries GNI is expected to be lower than GDP since outward FDI is

likely to be lower than inward FDI (Figure 8). The GNI can provide a more accurate picture of the national income available for domestic economic activities. On average, between 2000 and 2016, the country had a gap of around 5.5%, behind only Luxembourg, Ireland and Cyprus, countries where FDI plays a large role too. This gap has constantly increased in the 2000s, reaching a peak of 7.6% in 2011, before moderating in recent years. The other V4 countries, apart from Hungary, have noticeably lower discrepancies.

Figure 8: GNI-GDP gap and net inflows of FDI at the EU level (averages for 2000-2016)

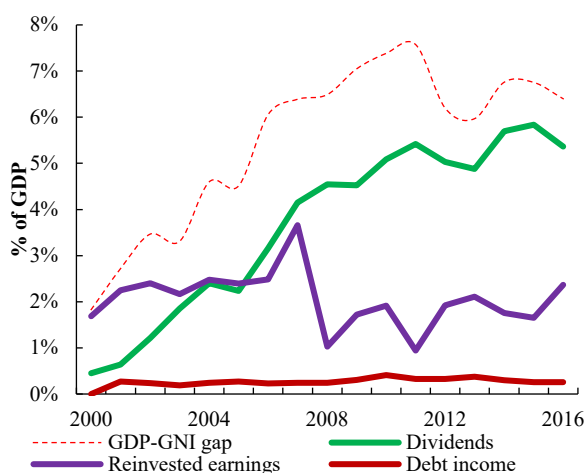


Source: AMECO database and UNCTAD statistics, own calculations

Note: Average figures between 2000 and 2016. LU, IE and MT not shown due to disproportionately large figures

The GDP-GNI gap is generated mostly by the distribution of dividends to the parent companies abroad. Averaging 3.7% of GDP between 2000 and 2016, dividends made up two-thirds of the GNI-GDP gap, with the rest representing other capital earning. Nonetheless, the evolution of dividends has driven the gap trend (Figure 9). Until the EU accession in 2004 their level was relatively low and below the level of reinvested earnings. After the accession, however, the share of dividends started to grow significantly, stabilising at around 5% of GDP and almost 68% of all FDI income. Out of the EUR 148 billion in income generated in the Czech Republic between 2004 and 2017, MNCs distributed around EUR 99 billion as dividends ⁽¹⁴⁾. The total FDI inflows during the same period amounted to EUR 67 billion. It should be noted, however, that Czech MNCs also repatriated EUR 4.4 billion in dividends from their EU subsidiaries. Nonetheless, as many of these investments are in the first phases of the profitability cycle, the reinvestment of earnings stood at around EUR 10.3 billion.

Figure 9: **GDP-GNI gap and FDI income**

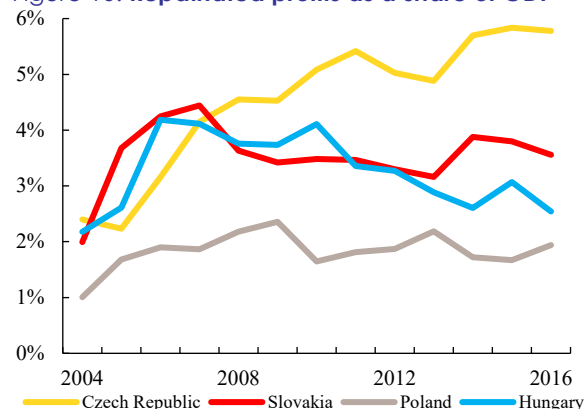


Source: Czech National Bank statistics, AMECO

Among V4 countries, the Czech Republic has the highest outflow of dividends as a share of GDP. Unlike in the other V4 countries, the share has been constantly growing, hovering at around 5% since 2010. In comparison, in Poland it rarely passed 2% annually. Slovakia and Hungary followed the Czech trend up to 2007 but, as of then, the rate has seen a downswing. In terms of volumes, the Czech Republic also witnessed the highest figures in V4. In Poland, an economy twice as large, the total amount of distributed dividends since 2004 has been slightly lower ⁽¹⁵⁾. In terms of the ratio of distributed dividends per FDI income averaged since the EU accession, with 68%, the Czech Republic comes second after Slovakia (72%). The shares in Hungary (57%) ⁽¹⁶⁾ and in Poland (50%) are significantly lower.

The repatriation of profits is not a region-specific phenomenon. Brada and Tomšík (2009) suggest that FDI has a profitability life cycle divided into three main stages. At the entry stage most MNCs are making losses and therefore do not distribute dividends. Later, in the growth stage, most earnings are reinvested in order to increase the market share. Finally, once the investments reach maturity, the focus shifts to profit repatriation, either as dividends for shareholders or as seed money for the MNCs to be used in other markets where investments are still in an early phase. Novotny (2018), for example, estimates this profitability life cycle to be around 16 years. Taking into account that most FDI in the Czech Republic was started in the mid-1990s, the profitability life cycle for many investments may have peaked around and or just after the financial crisis. Thus, on the basis of this theory, most MNCs that arrived in the country in the mid-1990s may currently have a lower incentive to reinvest their earnings as their investments may have reached the maturity stage.

Figure 10: **Repatriated profits as a share of GDP**

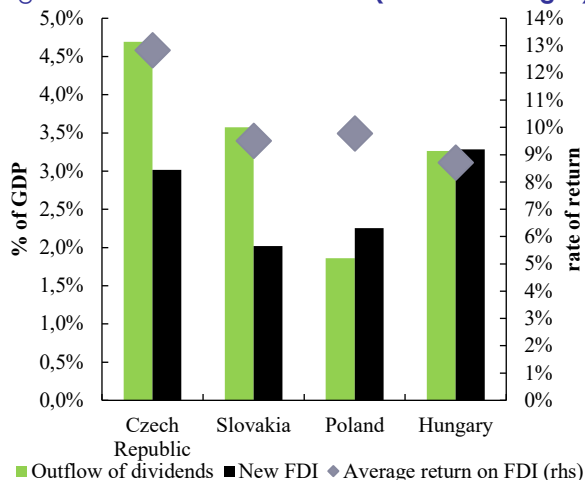


Source: statistics of the four central banks
 Note: figures on Hungary exclude FDI generated by SPEs

The repatriation of profits may seem problematic on the basis of a low inflow of new FDI. As a share of GDP, both the Czech Republic and Slovakia have a gap between the level of dividends going out and the inflow of new FDI coming in. By contrast, FDI inflows in Poland have been higher than the total amount of repatriated profits. This can relate to the fact that the Czech Republic and Slovakia may be more advanced in the FDI profitability life cycle. Hence, a significant amount of FDI in Poland may still be in the growth stage of the cycle and may still require a significant reinvestment of earnings. In the Czech Republic, due to shortages in terms of both labour force and greenfields or brownfields, most future FDI inflows will depend on the level of reinvested earnings rather than new capital

acquisition, which is expected to be lower than in the previous decade.

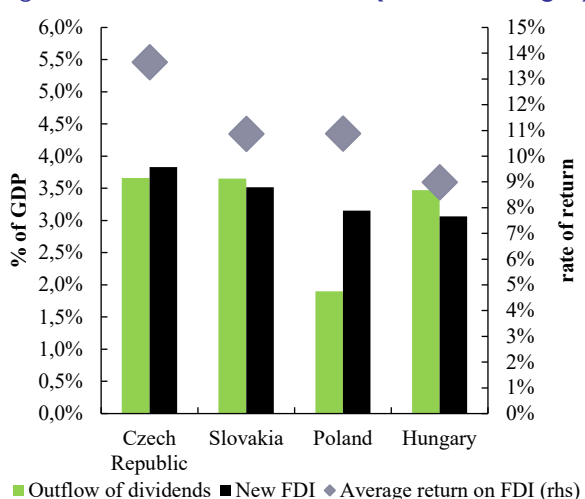
Figure 11: FDI flows in 2004-2016 (annual averages)



Source: statistics of the four central banks
 Note: figures on Hungary exclude FDI generated by SPEs

Before the financial crisis most V4 countries followed similar patterns in terms of inflows of new FDI and outflows of dividends. Apart from Poland, where inflows have been significantly higher, most countries witnessed a balance between the two between 2004 and 2009. On the other hand, as shown in Figure 12, rates of return in the Czech Republic were around 25% higher than in Slovakia or Poland and 50% higher than in Hungary.

Figure 12: FDI flows in 2004-2009 (annual averages)

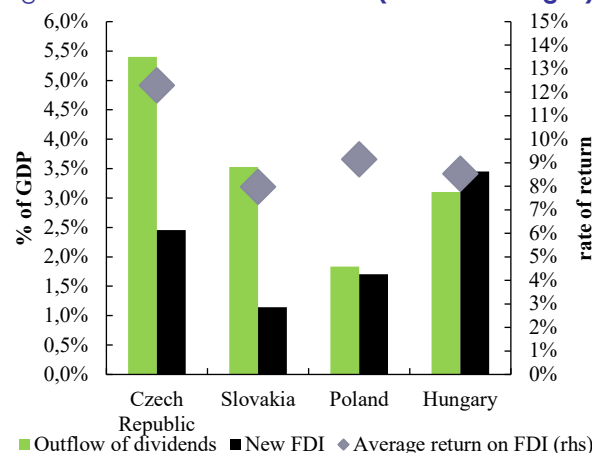


Source: statistics of the four central banks
 Note: figures on Hungary exclude FDI generated by SPEs

After 2010, trends in V4 have mostly diverged. Poland kept the same pace of outflow of dividends, while halving the rate of new FDI. Hungary has

been the only country where the share of new FDI was higher than in the pre-crisis period. The Czech Republic and Slovakia have witnessed different trends. While the share of new FDI plummeted in Slovakia from 3.5 to 1.1% of GDP, the outflows of dividends remained constant. In the Czech Republic, however, after 2010 the share of dividends went up by 48% while the share of new FDI dropped by 56%. Nonetheless, the rate of return on FDI remained high, dropping only 1.3% to 12.3%. Differences have persisted in the recent years as well. While in the Czech Republic EUR 29 billion were repatriated and EUR 23 billion were invested between 2014 and 2016, in Poland only EUR 12 billion were distributed as dividends and EUR 33 billion were injected into the economy.

Figure 13: FDI flows in 2010-2016 (annual averages)



Source: statistics of the four central banks
 Note: figures on Hungary exclude FDI generated by SPEs

The outflow of dividends varies depending on the partner country and economic sector. While investors from the Netherlands, Switzerland or the UK repatriated more than 70% of their income, Germany, Luxembourg and the major non-EU investors from South Korea and the USA distributed significantly less dividends⁽¹⁷⁾. The average has been influenced by the high rate of outflows to the Netherlands, a country that alone has generated a third of all FDI income since 2000. Excluding the Netherlands, the average repatriation rate would be 8% lower (Figure 14). The outflow is much larger in wholesale and retail than in financial services and motor vehicle manufacturing. While MNCs in the automotive industry have reinvested the most, those in the wholesale and retail trade sector have repatriated close to 70% of their income. In sectors other than manufacturing and services, over 85% of the profits have been repatriated (Figure 15).

Czech MNCs repatriated almost EUR 5 billion since 2004, mostly from Slovakia. This took place during and after the financial crisis when the outlook was less certain and companies may have taken

more conservative decisions. In the case of both inward and outward repatriation of profits, half of the dividends repatriated since accession were distributed between 2012 and 2017.

Figure 14: **Distributed dividends as a share of total FDI income and average rate of return by partner country**

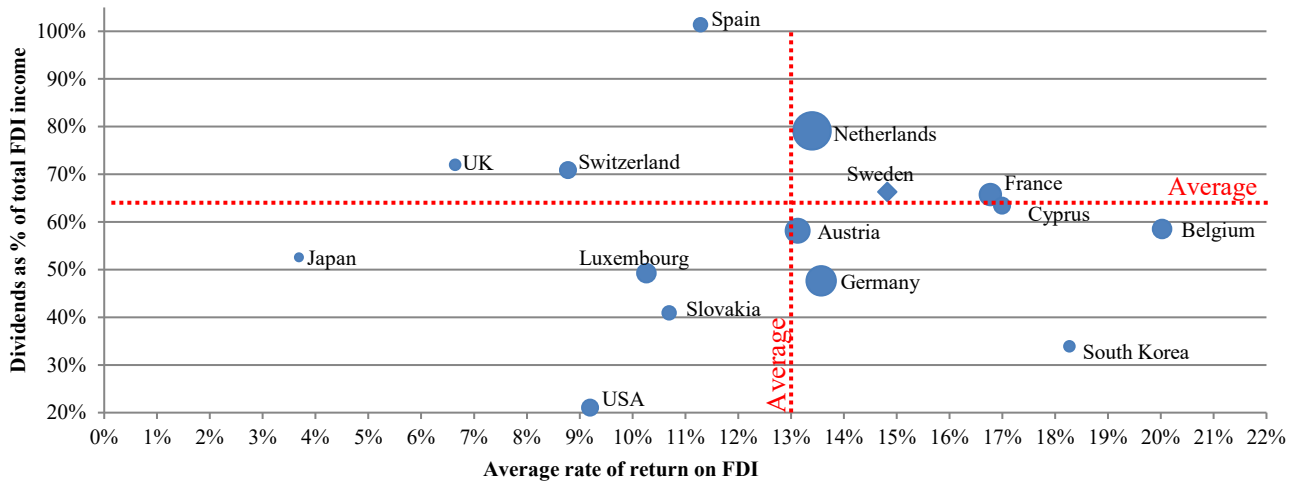
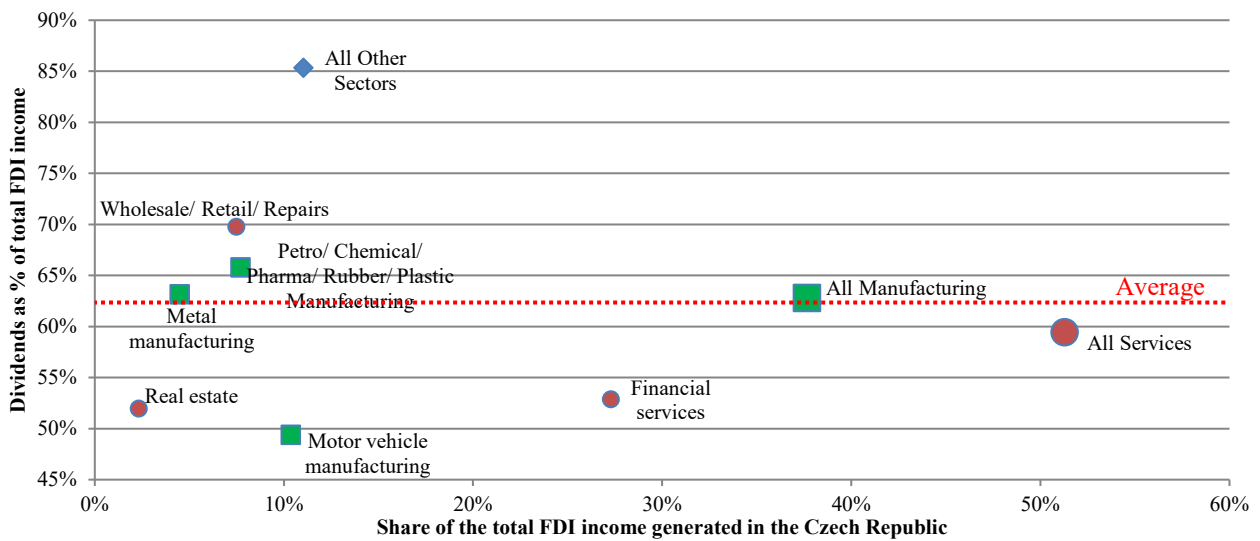


Figure 15: **Distributed dividends as a share of total FDI income and average rate of return by economic sector**



Source: own calculations based on statistics of the Czech National Bank

Notes: Average figures between 2000 and 2015. Size of bubbles reflects the share of total FDI income.

FDI contribution to the economy

The contribution of FDI to the Czech economy has been significantly positive even if the outflow of dividends has been high. While the amount of repatriated profits has been higher than the V4 average, the overall contribution of FDI to the domestic economy in areas such as investment, employment and government revenues has been significantly higher since the EU accession.

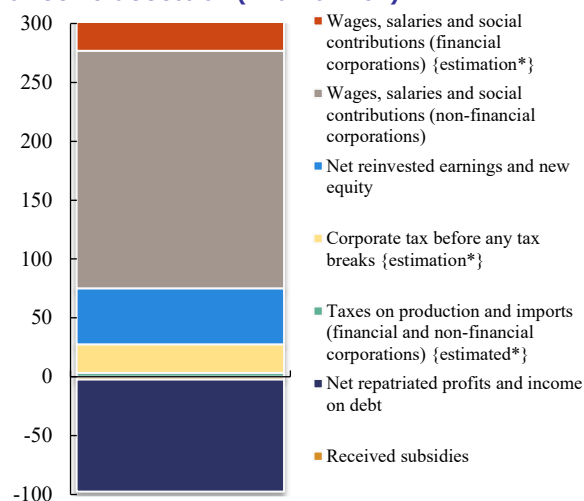
The amount of wages, salaries and employers' social contributions paid by the MNCs since accession has been significant. An estimation presented in Figure 16 suggests that the total amount of wages, salaries and contributions was more than double compared to the level of net repatriated profits. As mentioned, MNCs employ around a third of the total workforce and, due to increased labour productivity, can offer higher wages than the national average. Their contribution to the social security funds (healthcare, pensions, and

unemployment) has been equally important in the last decades and has contributed to the relatively good health of the Czech public finances on the short- and medium-term.

MNCs are an important source of tax revenue for the government. Based on the author's estimation, the contribution of foreign investors can be a relevant contributor to the government's revenues⁽¹⁸⁾. While it is assumed that many foreign investments received significant tax incentives during their entry phase (which could not be estimated in this analysis), over the years many MNCs have become significant contributors to the Czech budget. Additional revenues may have been brought by the withholding tax on dividends, but were also not included in this estimation.

Foreign investment can generate significant second- and third-round effects to the domestic economy⁽¹⁹⁾. While studies that analysed these effects found mixed results, most suggest that recently there has been some form of spillover on domestic firms in the heavily foreign-owned sectors, in the form of technological transfers, intra-industry knowledge transfers, higher entry rates and lower exit rates (Stančík, 2009; Kosova, 2010; Pavlínek & Žižalová, 2014). While, overall, it can be assumed that domestic firms have benefited to some degree from the presence of foreign firms, many still remain Tier 3 or, at most, Tier 2 suppliers to the MNCs. As this mostly relates to their embedment in the lower levels of the supply chains, it is up to the public authorities to provide them with the support needed to increase their productivity and value-added.

Figure 16: Author's estimation of the impact of FDI since EU accession (in billion EUR)



Source: own estimation based on statistics of the Czech National Bank and Czech Statistical Office.

Note: Figures represent total volumes between 2004 and 2016. Data of financial corporations was only estimated on the assumption that approx. 90% of the income account is generated by MNCs. The revenues from the dividend withholding tax and the total amount of tax breaks provided to the MNCs on the corporate income tax have not been included in the estimation.

The decision to repatriate profits from a host country is influenced by both endogenous and exogenous factors. As Novotny (2018) mentions, FDI, like any other type of investment is inherently profit-seeking. Various studies aim to provide some reasons why foreign investors may be more prone to repatriate more or less and some, but not all, could be addressed by the public authorities. Lundan (2006) or Brada and Tomšík (2009) list factors such as macroeconomic developments and general views of the host country, return rates on FDI, stability of the local currency, corporate governance decisions, the income and dividend tax policy in the host country vis-à-vis the home country or the opportunities for extracting funds from the affiliates through transfer pricing. Furthermore, as mentioned, MNCs are also less keen in reinvesting their earnings after their cumulative profitability reaches a maximum (Novotny, 2018). Other factors could relate to the structural challenges of the host country which may disincentive the MNCs to reinvest their earnings, namely labour shortages, global trade uncertainties, administrative burden and various public investment gaps.

Conclusions

The Czech Republic is one of the most FDI-intensive countries in CEE. The stock grew strongly in the first years after accession but has moderated since the financial crisis, partially due to an increase of repatriated profits. The largest immediate foreign investors are from the Netherlands, Germany, Austria and Luxembourg. Nonetheless, the Netherlands and Luxembourg do not feature among the ultimate major investors. Due to FDI round-tripping, almost 10% of the stock is generated by Czech companies via foreign affiliates. Financial services represent more than one third of the total FDI stock but motor vehicle manufacturing continues to be an important sector of investment.

Most of the FDI stock has been built in and around Prague. The capital region and the surrounding Central Bohemia account for around

70% of the total FDI stock. While the share of FDI to regional GDP in Prague is more than double the national average, half of the regions lag behind. What is more, the regional discrepancies have been constantly growing since EU accession.

As FDI reached maturity, there has been a significant amount of repatriated profits. As the Czech Republic has been the most profitable country in the EU for foreign investors, almost EUR 100 billion have been distributed as dividends since 2004, the largest figure in the region, leading to a significant gap between GDP and GNI. While these repatriated profits have been compensated by new foreign capital investment up to 2009, after the financial crisis the outflow of dividends has been significantly higher, even though the rate of return on FDI remained high.

The contribution of FDI to the national economy has been significantly higher than the outflow of dividends. Estimates show that the contribution of new FDI inflows, wages and social contributions and the amount of payable tax, before any tax relief, has been around three times higher than the net repatriation of profits. Second and third-round effects of FDI, including the spillovers to the domestic companies, have also had a positive effect.

The outflow of dividends is not a Czech-specific phenomenon. To various degrees, most converging countries witness an outflow of dividends and a gap between their GDP and their GNI. While differences exist, at least 50% of all income generated in V4 is repatriated. Most MNCs, including the Czech ones operating abroad, take their decisions at the group level and may decide to shift funds between the markets they operate in. They could, however, decide to reinvest more of their earnings if the Czech Republic improves its business environment, reduces the administrative burden and shows stability and predictability in political developments and fiscal policy. While labour shortages persist, MNCs could look into different paths on how to reinvest their earnings such as technology centres, research activities or shifting towards knowledge-intensive activities.

Investment can be promoted implementing several structural reforms. As mentioned in the latest assessments of the European Commission (2018), there is a need to reduce administrative burden on investment, especially as regards issuing building permits. There is also an urgent need to simplify the tax system and reduce the time needed

by investors for tax compliance. Furthermore, the bottlenecks hampering R&D and innovation need to be removed in order to shift investment towards more knowledge-intensive activities. The quality of the administration needs to be reinforced, especially in areas such as e-government, prevention of corruption and public procurement. Finally, FDI round-tripping should be reduced by strengthening the legal and business framework in the country. Furthermore, traditional incentives provided for FDI such as tax reliefs, tax breaks and cash grants should be provided in a way that does not discourage domestic entrepreneurs to invest in their own country and ensure tax transparency, fairness and compliance with state aid regulations.

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Annex 1: Definition of some of the terms related to FDI used in the Economic Brief

FDI is defined as “... a category of cross-border investment made by a resident entity in one economy (the direct investor) with the objective of establishing a lasting interest in an enterprise (the direct investment enterprise) that is resident in an economy other than that of the direct investor.” This lasting interest entails a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the enterprise. This is emphasised by a direct or indirect ownership of at least 10% of the voting power, or equivalent. Foreign ownership shares of below 10% count as portfolio investment positions in the Balance of Payments.

FDI stocks (positions) provide information on the total stock of investment at the end of the year in a reporting country. FDI stocks are broken down into equity, reinvestment of earnings, contributed surplus, revaluations, reserve accounts and debt. The FDI stock changes due to transactions (flows) occurring during the year, due to exchange rate changes or price valuation changes, or due to other volume changes.

FDI flows (transactions) relate to direct investment transactions made during the year in the form of equity capital acquisitions, reinvestment of earnings or debt transactions (in most cases loans or trade credits between affiliated enterprises).

FDI income represents the annual return accruing to direct investors for the provision of financial assets. The FDI income is divided between dividends (and withdrawals from income of quasi-corporations), reinvested earnings and interests. Reinvestment of earnings consists of the direct investor's share of earnings not distributed as dividends. Dividends include dividends payable or receivable gross of any withholding taxes, recorded at the time the shares go ex-dividend.

Statistics can be presented at the level of partner country and by economic sector with most data available at the immediate investor level. Since 2013, based on updated international guidelines for compiling FDI statistics, there has also been information /data aggregated at the ultimate investor level. According to OECD, this allows looking into complex ownership structure to see the country of the direct investor who ultimately controls, bears the risks and reaps the benefits of investment in a host country, including information about FDI round-tripping.

FDI round-tripping takes place when funds that have been channelled abroad by resident investors are rerouted to the host economy in the form of FDI. Round-tripping is mostly channelled through certain financial centres that provide preferential treatments to the investors. According to Aykut, Sanghi and Kosmidou (2017) motivations for this process vary from institutional and financial shortcomings in the host country to investment protection via various bilateral investment treaties, tax avoidance or even illegal activities in some extreme cases. This process does not offer all the benefits of FDI (i.e.: spillovers to the domestic economy) and can create significant tax loss and distorted competition in the host country. Most round-tripping is being done via eight major offshore financial centres that are responsible for around 85% of the world's investment in special purpose entities (SPEs), namely the Netherlands, Luxembourg, Hong Kong SAR, the British Virgin Islands, Bermuda, the Cayman Islands, Ireland and Singapore (Damgaard, Elkjaer and Johannesen, 2018).

When assessed via the **directional principle** (the direction of the investment), investment can be **outward** (made by direct investors of the reporting country in enterprises abroad) or **inward** (made by direct investors from abroad in the reporting country). The net position or net FDI is the difference between outward FDI and inward FDI. The **debtor/creditor principle** or the **asset/liability principle** can also be used but the net position needs to remain the same.

The **rate of return on FDI** is calculated as the ratio of the net income generated in year t+1 and the FDI stock in year t.

¹ Apparent labour productivity is the ratio between the value added at factor costs and the number of persons employed.

² 35% for companies from countries with whom a tax treaty or an exchange of information treaty has not been signed; otherwise a 15% tax applies if the foreign company is not covered by the EU Parent-Subsidiary Directive; if the Directive applies, no withholding tax is applied in the Czech Republic.

³ At 13.04% the Czech Republic had the highest return on FDI in the EU in 2015, followed by Lithuania (11.2%), Poland (9.68%) and Slovakia (8.18%). The EU-28 average was 3.81%.

⁴ According to OECD's (2017) Czech Republic Trade and Investment Statistical Note, the country had the highest rate of return on FDI among OECD countries in 2015.

⁵ The EU average is significantly influenced by the figures in a few small and medium-sized economies known for their FDI-friendly rules and regulations, such as Malta, Cyprus, Ireland, Luxembourg and the Netherlands.

⁶ Between 1993 and 2005 privatisation yields accounted for around 25% of all FDI inflows.

⁷ The large decline in inward FDI inflows in Hungary in 2015 is caused by changes in asset composition

⁸ Data on this has been only computed by the OECD since 2013.

⁹ The cases of the Netherlands and Luxembourg may deserve some specific attention due to their use of Special Purpose Entities (SPEs). As mentioned in the latest country reports issued by the European Commission in March 2018, the absence of broad withholding taxes on dividends, royalties and interest payments in these countries may suggest that their corporate tax rules could be used by certain companies to potentially engage in aggressive tax planning. On the other hand, literature suggests that the use of these SPEs in these countries could also be motivated by non-tax reasons such as investment protection, political stability and rule of law (Weyzig, 2013).

¹⁰ FDI round-tripping represents almost 9% of total FDI in the Czech Republic, compared to 4% in Poland, 0.1% in Hungary or 8% in Germany (no public data available for Slovakia).

¹¹ According to the US Department of Commerce's Czech Republic Country Commercial Guide available at <https://www.export.gov/article?id=Czech-Republic-Automotive-Parts-and-Equipment>.

¹² Certain foreign investors may set their headquarters in Prague and report their financial data there but at the same time invest significantly in local branches all around the country.

¹³ The only shareholder of Foxconn CZ s.r.o. is Foxconn Holdings B.V., a company registered in the Netherlands and a subsidiary of Hon Hai Precision Industry Co. Ltd from Taiwan, trading as Foxconn Technology Group.

¹⁴ 94 billion EUR were repatriated to other EU Member States and 5 billion EUR to non-EU countries.

¹⁵ According to the statistics of the National Bank of Poland, 85 billion EUR have been distributed as dividends between 2004 and 2016.

¹⁶ Data for Hungary excludes FDI generated by SPEs.

¹⁷ This can be explained partly by the different taxation standards, particularly in the case of the USA.

¹⁸ According to the OECD benchmark manual, the FDI income should be reported net of corporate income tax and gross of any withholding tax on dividends. The estimation in Figure 16 is based on this assumption.

¹⁹ Second-round effects mostly include technological spillovers of foreign enterprises to domestic companies. Third-round effects can arise "through the impact on public goods provision and expenditure of any increased tax revenue that might be associated with FDI" as suggested by Reinert et al. (2009) in The Princeton Encyclopedia of the World Economy.

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