

## comercio internacional

**I**s the Czech economy a success story? The case of CzechInvest: the strategic promotion agency in Czech industrial restructuring

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## Abstract

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The study of CzechInvest, the leading and most prestigious investment and business development agency in the Czech Republic, seeks to describe and analyze the principles underlying the promotion of investment, restructuring and innovation in a country that has undergone a fundamental transformation of its economic, social and political operations in the last 18 years. The country is an interesting example for countries facing the challenges of growing openness to globalized markets and the need to restructure their international exchange patterns and institutional arrangements. The report shows how restructuring policies were channeled through the investment promotion agency with a flexible adjusting and “trial & error” approach to design policy instruments and to changes in the real world, while facing the dangers of corruption, bureaucracy and political capture.



## I. Introduction<sup>1</sup>

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This study of the CzechInvest promotion agency is a part of a broader research project analyzing the principles, objectives and instruments of Czech economic restructuring. It seeks to describe and analyze the principles underlying the promotion of investment, entrepreneurship, restructuring and innovation in a country that has undergone a fundamental transformation of its economic, social and political operations in the last 18 years. We will concentrate on points of general importance that can be used for comparison with policies in other countries —especially those countries facing the challenges of growing openness to globalized markets, the need to restructure their pattern of international exchanges and the pressure to reform their institutional arrangements.

CzechInvest is the leading and the most prestigious investment and business development agency in the Czech Republic. It operates under the aegis of the Czech Ministry of Industry and Trade (MIT). It was set up in 1990 as part of the sweeping political, social and economic changes that began with the Velvet Revolution in November 1989. Another catalyst in the reorientation of policies was the division of Czechoslovakia, which burdened the country with additional restructuring costs. The most important calling for Czech and international society, however, began in 1997 when the government assigned CzechInvest a new path-breaking mission: to open Czech society to the globalized world by promoting foreign direct investment (FDI). In the original design of the transition plan, the motor of change was intended to be internal, exemplified by the

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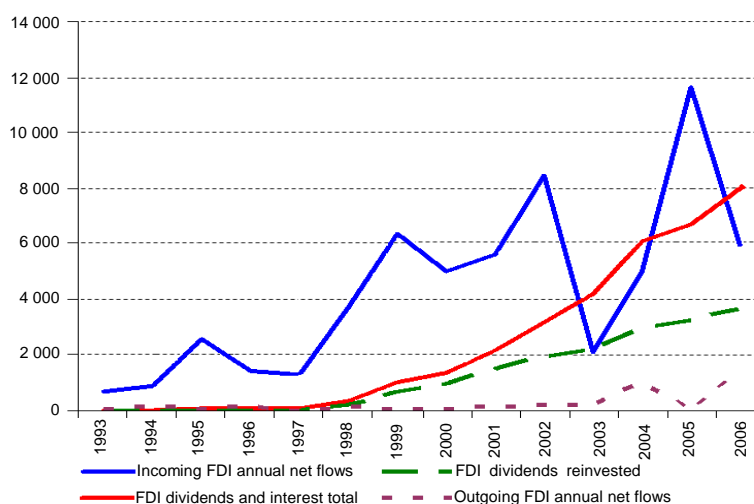
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voucher privatization scheme and generous loans from state-operated banks. From the outset the idea was to attract foreign human capital along with inflows of financial capital. The stress was laid on greenfield projects, not foreign acquisitions. The program allowed for spillovers of foreign capital and knowledge into the indigenous sectors, so that the rising quality of production and management would remain the drivers of growth for the whole economy. The government was aware that it had committed itself to a costly venture: any FDI inflow should be paid for by high dividends.

The Czech Republic, with its adverse results from mass privatization, poor protection of property rights, collapsing banking sector and dysfunctional legal system, was considered a risky economy. Thus it was obvious that foreign investors would come to the Czech Republic only if the dividends were higher than the standard 10–12 percent annual returns earned from FDI in stabilized economies. In order to lower the risk premium, the government was willing to offer conditions for FDI entry that would signal a strong government commitment to support foreign ventures and mitigate the risks.<sup>2</sup> It was not only a matter of substantial subsidies that should be proportional to the expected value of spillovers internalized by the domestic sector; the program was to signal a clear alliance between the government and foreign investors by offering them cooperation in a highly investment-friendly environment.<sup>3</sup>

Very soon, CzechInvest launched the most ambitious promotional scheme among all the post-communist countries in Europe. Its principles revealed its inspiration in the Irish and Scottish experiences, as well as the principles outlined by MIGA/FIAS of the World Bank (Morisset, 2003). Significant innovations were made to the scheme in 2000, and in 2004 it was substantially re-directed to broader targets. After CzechInvest's breakthrough in 1997, FDI policies in most of the region's transition countries (such as Hungary, Slovakia and Poland) had to be revamped. Opening the post-communist economies to the competition of world financial capital and world markets became their most important policy. Thereafter it was clear throughout the world that the prosperity of post-communist economies in Europe and Asia are bound to derive from their liberal policies of opening-up in areas where the government had an important coordinating role.

**FIGURE 1**  
**CZECH REPUBLIC: FDI INFLOWS AND OUTFLOWS, 1993–2006**



Source: Czech Balance of Payments, 2007

<sup>2</sup> It was a pleasant surprise when, after 2000, the dividends and interests paid by FDI firms did not surpass 12 percent of the value of FDI stock. Of course, we should also calculate the hidden net transfer payments due to the MNC practices of optimizing corporate tax payments. Nevertheless, until 2007 the Czech “dividend burden” in the balance of payments was still quite low because about half of the dividends are re-invested in the Czech Republic, as shown in Figure 1.

<sup>3</sup> This aspect of the scheme became a bone of contention for some NGOs, which saw this step as an attempt to create a subservient “comprador service sector” that discriminated between foreign and local investors (Drahokoupil, 2007; Franc and Nezhyba, 2007).



Of particular interest in looking at CzechInvest is its flexibility in policy adjustments. Its policy targets evolved quite dramatically over time, reflecting the changing nature of the reforms. Starting as simply a freelance investment mediator with no effective powers, it became a large institution with a staff of 320 and the following attributes:

- Structured degrees of freedom at various levels of national decision-making;
- powers to implement interministerial coordination;
- authorization for strategic and operational servicing of both foreign and local investors;
- targeting European structural and cohesion funds;
- CzechInvest's internal management comprises three skills:
- learning from the successes and failures of policies abroad;
- domestic (local) perception of international challenges;
- reliance on domestic human resources by offering new opportunities to the young.

The next two sections briefly describe the characteristics of FDI and then address CzechInvest's policies as they evolved over time, since each period required different responses. The study also describes how the agency functions, comments on its most important programs, and assesses how successful they were at meeting certain goals.

Our aim is not to decide whether it is good or bad for a country to attract foreign investment. That is a matter of making specific commercial calculations about each venture in each country. Rather, we concentrate on more practical goals —particularly, on describing the specific institutional backdrop of one country that experienced extraordinary advances in the quantity and quality of exports. Though it is tempting to ascribe causal relationships to such effects, we should keep in mind that CzechInvest's policies were only a small part of more dramatic changes. Many of them were even spontaneous, and the government had to adapt to them. This is one of the crucial lessons: there is often a need for light, but the government should not shine all night and day. Very often it is enough that it does not cast a shadow.

There is a trinity of economic agents (enterprises, governments and citizens), the trinity of their organization (through markets, hierarchies and informal networks), and the trinity of objectives (wealth, welfare and contentment). The keys to success in restructuring and development also lie in bringing these trinities into productive co-action. We can speak about cooperation or even an alliance among them, through efforts to bring about their balanced co-existence abound in conflicts that have to be resolved. The resulting externalities of convergence to socioeconomic harmony, patience and trust have various effects, including economic growth and mutual innovative exchanges. Our aim is to inspire thinking about how to work with foreign investors and how to obtain externalities from their presence once a country decides to do so.

Now, 10 years later, we should look back and assess whether the stated goals were met. The criteria might be as follows:

- Did incoming FDI bring with it additional externalities in the form of higher economic growth, inflows of human capital and spillovers into local sectors?
- Were the Czech counterparts in the partnership able to absorb the externalities offered by massive FDI inflows?
- Were the Czech servicing organizations partners of equal standing with foreign capital or were they simply subservient “compradors” happy in their ignorance and ripe for corruption?
- Did the scheme allow Czech entrepreneurs to prosper or were they crowded out from dominance in the Czech economy?

The fundamental question seems to be the following: Did the scheme operated by CzechInvest open Czech society to a real partnership and active participation in the globalized world economy (a complete reversal of the communist approach to international cooperation), or was society marginalized and the chances for sovereign development thwarted?

Some answers to the question are given below. It is obvious that the Czech economy had revived with the entry of FDI and foreign companies became the leaders in economic restructuring. The country's economic environment changed dramatically after its banking sector was privatized and laws were enforced against breaching contracts and infringing property rights. The rise of large local entrepreneurs was also remarkable. Rentseeking activities began to disappear significantly from the sector exposed to international competition.

Nevertheless, to date there has been no comprehensive analysis of the costs and benefits at the national level, one that compares the direct and indirect benefits of FDI with similarly assessed national costs (such as the costs of incentives, dividend outflows, losses from relocation and induced bankruptcies). There are some partial studies that use scientific procedures and whose generally positive findings of links between foreign capital and national prosperity in the Czech Republic and the broader region cannot be denied. At the same time, there are biased studies that have made partisan efforts to prove either positive or negative effects of FDI. Now is the time to embark on a more fundamental analysis of what happened in a society that reversed its development strategies from national isolation to a fully-fledged openness to globalization. the Czech Republic could be a leading case study in that respect.

## II. General characteristics of FDI

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It is essential for any country that seeks to catch up or restructure its economy to assess its capital endowments. Often, capital constraints curb development. In the Czech Republic, about a quarter of the physical capital inherited from 42 years of communism had to be scrapped within the first two years of transition (1990–1991) because it was allocated to production without demand. Its workers had to be transferred to new capacities. Many of them were supposed to establish new businesses of their own, or to work in startups that were short of capital. Another 40 percent of all physical assets were antiquated or had to be reallocated to alternative uses at high costs. They had to be written off after about seven years and replaced by new facilities and equipment. Additionally, the standard wear and tear on equipment required annual investments for recovery at 6 percent of their real face value. The annual capital costs of restructuring alone (that is, without extending previous capacities) thus accounted for about 30 percent of GDP and would have to be spent continually during the first 10 years. The high growth that was expected to follow restructuring would have to build additional production capacities at an accelerating rate—that is, an additional increase in production of US\$ 1 billion would require an investment of US\$ 3 billion.

Fortunately, the Czech economy had historically high saving rates, which had to be retained. Hence the National Bank had to offer positive interest (in real terms) on deposits. As a result, households and businesses saved on average 29 percent of GDP until 1999. Later, this pressure was able to attenuate. As mentioned, however, the capital investment requirements for restructuring and growth amounted to about 30–36 percent of GDP. This would not have been possible without sources of finance in addition to national savings. Thus a resort had to be made to government debt, an expansionary monetary policy and inflows of foreign

capital. The value of annual FDI flows increased from 2.5 percent of GDP in the period 1991–1997 to an average of 8 percent of GDP in 1998–2006.

FDI's most important externality is that it is accompanied by additional human capital, advanced technologies and access to world marketing networks. Without their presence the costs of FDI (repatriated interests, dividends and transfer payments, which are estimated in the Czech Republic to be in the range 14–22 percent) would be too high. Only then can policies to attract FDI be justified. This means that outgoing profits in excess of standard interest payments on capital acquired by alternative means (perhaps a loan at an interest rate of 8 percent) should be treated as premium payments for the externalities of FDI. Success in the acquisition of FDI can be then measured by the value of externalities (spillovers) per outgoing profits.

This also means that the management of the public funds used for externality/spillovers/attraction via FDI has to be subject to prudent rules, accountability and a constant assessment of returns. The Czech solution was to entrust CzechInvest with this complex and professionally very demanding commercial agenda. Until 1997, however, government support for general investment financing was prudent: the budget was often in surplus, FDI was not promoted and policies of easy access to credits brought the banking sector to the verge of bankruptcy. At the same time, the quality of investment by locals (that is, its innovation content and high returns) was unsatisfactory.

## A. Structure of Foreign Direct Investment as a policy objective

Using the definition of the United Nations Conference on Trade and Development (UNCTAD), FDI comprises “investments made to acquire lasting interest in enterprises operating outside of the economy of the investor.” Relevant to this study are the institutional arrangements (mainly the policies) that support the quality of domestic investments in general. For that we will have to work with definitions of FDI based on their targeting. We will use four categories that are well known from the FDI literature.

First, *greenfield investments* are supposed to be most valuable. According to Rodrik (2004: 14): “it is activities that are new to the economy that need support, not those that are already established.” Such FDI requires a high volume of initial capital, new technologies and new marketing strategies. It also brings the most valuable asset: a breakthrough on the path to *new* comparative advantages. Success in this latter regard is crucial factor to the outcome of economic restructuring as a whole.

Second, *brownfield investments* are in areas that were used for industrial purposes but had to be refurbished from scratch. It is usually assumed that this type of FDI has lower initial costs than greenfield investment, though the Czech experience indicates that investors often may not think so: there are risks associated with cleaning up pollution, property litigation and former crony networks that impact on public opinion. There are also additional social objectives (such as social cohesion or returning the unemployed to work) that induce governments to offer special schemes to such ventures, which otherwise would not be particularly attractive to foreign investors or conducive to economic growth. In the end, brownfield investment costs the government more than attracting a greenfield investor.

Third, *mergers and acquisitions (M&A)* are another type of FDI. Their main characteristic is that they comprise a transfer of property rather than an investment, and thus neither job creation nor technology imports are guaranteed. In the early stages of post-communist transition, when privatization was the dominant government policy, M&As as ownership transfers to new strategic owners<sup>4</sup> became the main vehicle of economic recovery. As modern markets are subject to oligopolistic competition, export penetration of western markets was often tied to an M&A takeover at a price that reflected the threat of bankruptcy as an alternative. M&As can hardly become vehicles of breakthrough. Recalling

<sup>4</sup> In the Czech case practically all such new owners of former large state-owned enterprise (SOEs) had to be found abroad, as was discovered only later, when most new local entrepreneurs turned out to be rent-seekers because they found their power to penetrate oligopolistic markets to be highly deficient.

Rodrik's observation mentioned above, turning portfolio investments into present comparative advantages does not deserve particular incentives, though they can bring a higher rate of export penetration and improve the terms of trade. They should be attractive enough by themselves. On the other hand, industries with clear comparative *disadvantage* are not worth resuscitating through special government schemes.

Fourth, *joint ventures* with local enterprises are advantageous for both sides, especially in cases of outsourcing and offshoring. Foreign companies can access the local market and domestic firms can expand abroad. The whole local market can also profit from spillover effects. This kind of FDI penetration is characteristic of domestic firms that have already been partially restructured and that can assume the responsibility of an equal partnership. This definitely merits coordination support on the part of the government (though MIT or CzechInvest, for example) but it cannot become a policy of strategic importance. In the Czech case, after five years of booming inward processing traffic (IPT) in the textile and clothing industries, joint ventures became a marginal source of FDI.

Returning to CzechInvest's strategies, their priorities were also ranked in the descending scale outlined above according to their social gains, which were deliberately targeted by policies after 2000. CzechInvest gave fully-fledged support to less than 25 percent of all investments (measured by value).<sup>5</sup> Greenfield investments as a top priority were again ranked according to their potential for externalities: strategic FDI was supposed to be the pioneer with a marked demonstration effect, bringing funds accompanied by new technologies and know-how. Its potential for attracting joint second-wave investments, thus creating a chain (or even a cluster or agglomeration whose spinoffs would bring prosperity to the whole region), were also considered.

## B. Spillovers and externalities

CzechInvest's strategy sought to attract the positive externalities of FDI from its very inception. FDI can be treated as a public good: acquiring it entails substantial private costs but part of its productive benefits can be appropriated freely (or at a discount) by surrounding free riders as a trickle-down effect. If the leakage of benefits is too high, investors must be compensated for the losses. The problem is that the leaking spillovers can be absorbed domestically only if the gap between local and foreign technologies and management is not unduly wide. In fact, the Czech Republic's gap relative to FDI competitors widened sharply during the 1990s; at its peak in 1998 it amounted to a productivity lag of more than 80 percent. CzechInvest and (especially) MIT responded by introducing special programs that helped Czech firms to close this gap. We can distinguish between the following spillover effects.

First are horizontal spillovers that affect the competing companies. These spillovers can proceed through the competition effect (Czech companies try to match the quality of the foreign company), the demonstration effect (Czech companies imitate the behavior and technological procedures)<sup>6</sup> and the labor pooling effect (the employees or managers of a foreign company acquire skills at the foreign enterprise and later use them in a local company or establish a venture of their own).

Second are vertical spillovers, occur between a foreign company and either its local supplier ("backward linkage") or local customer ("forward linkage"). Supply networks and the efficiency they gain through economies of scale are the key drivers of globalization. Thus it is also of interest to foreign investors when their suppliers raise the quality of products and can supply them under just-in-time

<sup>5</sup> In the beginning, CzechInvest's FDI support concentrated on manufacturing industries and investments above a certain minimal limit, which fell from US\$ 50 million (valid until 1998), to US\$ 25 million, US\$ 10 and US\$ 5 million by the end). Investment in banking, real estates, telecommunications, sales networks, energy infrastructure and the portfolio of government-held equity was explicitly precluded from the incentive schemes.

<sup>6</sup> This is extremely important because it uncovers the unknown "cost structure" of a product or technology that could now be produced without much risk of investment failure.

conditions. The same happens when a FDI firm supplying intermediate products helps the local customer to penetrate world markets.

Enterprises' isolation from world markets and comparative advantages under central planning could not be broken instantaneously. The process of transforming businesses often lasted up to 10 years. Thus it is very useful to have policies that supported learning how to compete and cooperate with foreign corporations, how to absorb their positive spillovers, and how to resist their negative externalities. After 1990, the task of designing and implementing such policies was the responsibility of the Ministry of Industry. Its post-communist bureaucracy, however, was virtually incapable of such an endeavor. Investors were actually deterred by the ministry's approach to business, and thus ever more of the effective investment services were informally taken over by the more entrepreneurial CzechInvest, which was originally established as a mere consultancy.

Industrial policies have their supporters as well as their staunch adversaries. Since this study deals with such policies, readers should be aware why it is presumed here that these policies have their place in economic restructuring and development. The argument is presented in Box 1.

#### BOX 1

##### MAINSTREAM FACTORS EXPLAINING EARLY SWEDISH ECONOMIC GROWTH

Although the history of industrial policies targeted at export promotion and competitiveness dates to the mercantilism of 500 years ago, it was in the planned economies that they peaked. The more recent idea about a strategic collaboration between the private and public sectors to dismantle the barriers to restructuring and to bring markets and entrepreneurship to a high level of performance brought industrial policies back to prudent deliberation. In the last 30 years new theoretical underpinnings for industrial policies have been developed, led by the discipline of economic geography, as have new trade policies based on oligopolistic competition, increasing returns to scale, economies external to the firms, intra-industrial specialization and product differentiation (see Krugman and Obstfeld, 2003: 120–159). The stress placed on encouraging the initial movers to gain advantage in competition and entrepreneurial innovation led to strategic trade policies (Krugman and Smith, 1994; Streblov, 2002) and to the support of entrepreneurship as a response to market imperfections (Leibenstein, 1995).

Rodrik (2004) locates the role of the government in overcoming information traps and coordination externalities, where there is a conflict between innovative entrepreneurship (which has private costs) and the returns gained by outsiders or even competitors. Promoting the proliferation of such externalities (e.g., by subsidizing the original investors) is of a great importance for society, since the country can then develop a large cluster of industries around the boom of the initial mover. In such circumstances, too little and too much competition discourages innovative entrepreneurship. The economy stagnates as everyone adopts a waiting strategy while the world moves on. Thus the government can temporarily break the ensuing deadlock by appropriate policies encouraging the entry of new leaders.

Source: Author.

## C. Pros and cons of FDI

Like all other transition economies, the Czech economy had to overcome a large number of obstacles to innovative decision-making from the first moments of the transformation. From within there were embedded social networks as the legacy of former communist hierarchies. From without there were the pressures of ideological interests that followed non-interventionist libertarian policies. As a result, official political power heavily opposed market interventions of any kind, suspecting that left-wing lobbies were behind them. On the other hand, there was the belief in self-enforcing and self-sustaining free markets. The assumption was that markets build their own institutions automatically, overcoming opposition from the “visible hands” of various pressure groups. It was the shock of the second transition crisis (1997–1999) arising from the neglect of property rights institutions that cleared the way for new policies of active cooperation between the private sector and the government. As pointed out by Olson (2000: 163): “To achieve rapid economic growth ... a society also needs socially-contrived markets and (property) rights-intensive production.” This is not possible without re-inventing the roles of the

government. In the Czech Republic in 1997, such a sweeping idea was to cede a large part of the economic responsibility for restructuring to foreign investors, while the government would remain responsible for designing general guidelines for their operating conditions. A political battle had to be won in order to confer such a strategic mission on CzechInvest.

On the basis of the Czech experience, let us consider the arguments in favor of attracting FDI and in opposition to it. Policies never have just one objective or one criterion. According to the Tinbergen-Mundell model, the number of instruments must at least be equal to the number of objectives targeted. Industrial policies are an additional instrument for targeting more than one objective. But the situation becomes even more complicated if the objectives are not complementary (that is, there are trade-offs between them).

Mencinger (2003: 491–508) points out that with FDI there are seldom benefits without costs, and sometimes costs outweigh the benefits. One of the prime issues in discussions of FDI is employment, which does not have to be positively correlated with rising wages and output. Nor does progress on restructuring imply greater job security. Every statistical table on the estimated effects of FDI has a column expressing the number of new jobs. The problem is that a high rate job creation is not always a gain for the region. In the post-communist period there were pockets of high unemployment in each country, often in regions that prospered under central planning. For example, Czech policies to attract of FDI to brownfield sites in the Kladno mining and steel region succeeded in creating many new jobs. Unfortunately, however, these jobs were so specific that they were filled labor from Moravia (200 kilometers away) and from abroad. The investments did not lead to a fall in the region's unemployment rates.

On the other hand, the industrial park built by the municipal government in Pilsen and supported by CzechInvest's policies yielded different results (see the case study in the appendix). This area is just across the street from the Skoda industrial estates that used to employ nearly 40,000 workers. Efforts to convert jobs in heavy machinery into jobs in electronics were more successful. When many employees were dismissed because of restructuring after the mid 1990s, workers literally crossed the street to secure a new job in Panasonic and in other smaller firms mushrooming around it. So even though the unemployment statistics did not vary over time, the supported investment helped bring about a fall in the unemployment rate.

Some opponents of the plan for an industrial park—which was to receive US\$ 15 million from the public budget—argued that it was too costly (in this case CzechInvest played the role of a coordinator that would fit perfectly with Rodrik's new types of strategic trade policies). But the industrial park now employs 11,000 workers in firms that invested US\$ 480 million. The courage of public administrators in making the first move to introduce a new electronics brand to the region led to the creation of an electronics agglomeration with annual growth rates over 20 percent. Both the Matsushita investor and the local and spin-off businesses related to electronics had to be pushed to discover that the Czech Republic was an optimal target for their investments.

Another important CzechInvest experience with regard to unemployment is that not all FDI must necessarily create new jobs. As observed by Zemplerova (2006), a common outcome of FDI inflow was a negative horizontal tradeoff against incumbents. This can even strike twice. First, as new and more efficient management policies were adopted, nearly all enterprises had to reduce their workforce, which was actually hidden unemployment. Without redundancies there could be no restructuring, and its costs and benefits were not symmetrical in time. First came the abrupt costs, and only later did the benefits gradually materialize. Thus a breakthrough in development could not be achieved without policies that backfired.<sup>7</sup>

The second blow comes when the initial comparative advantage in factor endowments is reversed. In economies subjected to intensive restructuring, labor is abundant and capital is scarce. Thus wages are depressed and new development is based on investments in labor-intensive products and technologies. Unemployment is mainly frictional (structural). As development accelerates, robust investments raise the

<sup>7</sup> There is a political paradox arising from such a necessity—the most successful and appropriate policies were nearly always “rewarded” by ousting the reformers from the government. The opposition could then enjoy the fruits of previous policies. It could claim the gains for itself while new policies could be neglected. The next government had to start with a new round of reforms, the costs of which were bound to be ascribed to its debts. This explains the excessive volatility of politics in transition countries.

capital endowments and wages rally. The comparative advantage gradually reverses to capital-intensive industries. Labor has to relocate again but the new capacities are labor-saving. Previous frictional unemployment thus becomes more dangerous, chronic unemployment. An outcome is “Dutch disease,” as explained by the Rybczynski hypothesis. The Czech economy suffered from this in 1997–2005. Unfortunately, some observers erroneously ascribed the problem to investment policies that correctly targeted the most efficient allocation of resources. The problem, however, lies in wage stickiness and in the lack of complementary policies to support new job creation—for example, by insufficiently promoting small and medium enterprises (SMEs).

The lesson to be learned is that the employment goal, which is parallel to the efficiency goal, cannot be always met by investment incentive schemes alone. Modern industrial policies that are compatible with market mechanisms usually target the competitiveness of local producers. There would scarcely be cause to use it if externalities and the aforementioned spillovers did not arise. In a zero-sum game, a counter-argument would be valid: a foreign company that settles in the country just ruins other local enterprises in the same business. There is no net gain and society loses from both the cost of the incentives and the dividends flowing abroad. Effective FDI entry thus cannot be treated as a zero-sum game. There must be some value added vis-à-vis the opportunity cost: higher output per worker, better quality, an improvement in the balance of trade, management spillovers, greater access to world markets and so on.

A very persuasive argument used by advocates of investment policies is the fact that all countries in the region use them. If a given country wants to keep pace, therefore, it has to establish an incentive program as well, even if reluctantly. This argument recalls a prisoner’s dilemma, and it became especially powerful after Germany secured an exception from incentives limits from the European Union (EU) for its “new” territory in the East, and when Hungary launched its privatization scheme directed at foreign investors. It is generally false. It assumes that the costs of relocation and its yields are the same everywhere and the only difference is in the subsidy that cuts investment costs by approximately 15–30 percent. In fact, the differences in the cost structure of all entrepreneurial ventures in different cultures and under different institutional arrangements are enormous. In addition, there are positive spillovers.

Hence a grand debate has begun in transition countries since 1990: Are FDI incentives worthless because they target companies that would settle in the country anyway? Is it not better to concentrate on fine-tuning the institutional setup? On the other hand, the supporters of investment incentives argue that industrial policies are effective because they target companies that are in their final phase of deciding on relocations in several countries, and that are unable to estimate their real cost and benefits with certainty. Thus the subsidy is the only firm data their managers have at hand. The leading supporter of the former approach is Václav Klaus, former Finance Minister, Prime Minister and currently President. He claims that no company would ever admit that an incentive subsidy is of a marginal importance, once the government reveals the will to pay it. In fact, in the period 1990–1996 Mr. Klaus did not give any preferential treatment to FDI, and the country’s investment performance lagged far behind that of Hungary (a country of similar endowments that underwent similar economic restructuring), which offered special FDI incentives from the outset. In the period 1994–2000, Hungary’s average export growth rates were 17 percent, double that of the Czech rates. It was only in 2000 that the Czech Republic overtook Hungary, once the new foreign companies launched production.

Martin Jahn, the former chief executive officer of CzechInvest, claims that Czech incentives were important, although they were not dominant. A quantitative study revealed that foreign companies considered the following factors: cost and skills level of labor, geographical location and, last but not least, investment incentives that acted as a catalyst (see Jahn, 2002). We can presume that for whole of the 1990s the institutional infrastructure in all transition countries was highly opaque and thus difficult to compare quantitatively. The incentive schemes were often interpreted as a government pledge to relieve the investors of institutional impediments and bureaucracy. Somehow this relieved them of the most pressing uncertainty of their investment. Some cynics therefore interpret the FDI incentives as a bribe that governments pay in order to compensate for institutional obstacles to investments they are unable (or unwilling) to eliminate.



Opinions against investment incentives often mention that projects which had preferential access to the Czech economy thanks to incentives profited from the moral hazard of opportunistic rent-seeking. Thus subsidies are biased towards footloose FDI with low sunk costs. In particular this affects simple assembly-line projects that enter with an incentive, manufacture their products for a couple of years, and then easily leave when they obtain another incentive elsewhere. FDI is then interpreted as a means of adverse selection rewarding poor projects.<sup>8</sup>

As this short summary shows, opinions on whether to attract FDI vary greatly. Theoretical economists (in contrast to local business people and politicians) approve investment incentives and subsidies for projects with high externalities whose returns mature in the long run. Their stress is on support for *activities* (not industries as such) that promote entrepreneurship that is prone to strategic collaboration, the creation of agglomerations, clusters and non-traditional activities based on R&D, technological centers, SME development and university cooperation. Incentives therefore promote externalities, which would otherwise be in shorter supply. They are market-compatible or even market-enhancing. By promoting market winners, they underpin comparative advantages and lower transaction costs. Market decision-making is therefore more transparent and the reallocation mechanism acts faster.

This was the orientation of CzechInvest policies after 2000. Unfortunately the voices advancing the matters of public goods, externalities, spillovers, learning by doing and protection of innovators in promoting the country's competitiveness have been overshadowed by more pragmatic issues, such as access to public finance for alternative (and less competitive) national claimants.

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<sup>8</sup> J. M. Keynes had joked that financial investments have a particular attraction for people of basest character. Perhaps the Czech strategy of waiting also had a silver lining: the opportunists and *arrivistes* had already exhausted their chances in other countries of the region.



### **III. CzechInvest in changing times**

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We can start with a summary of CzechInvest's general characteristics. It is a public agency that supervises a large part of the industrial policies in the Czech Republic. It is active in FDI attraction and enterprise development, and provides the following services to investors:

- Help with information on investment opportunities;
- investment incentives and subsidies;
- interface between investors and the Czech public administration;
- supply chain clustering, zone development and supplier development;
- SME development;
- access to EU funds; and
- R&D and quality promotion.

CzechInvest received international acclaim for its pathbreaking strategies and swift adjustment to changing conditions. According to the OECD (2006: 63), in its recommendations on policy reforms in the countries of Southeast Europe:

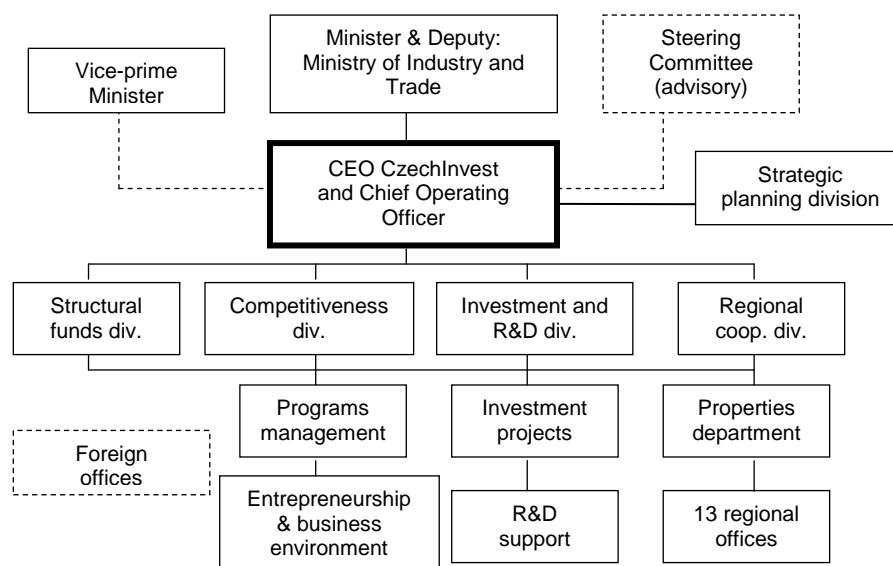
“The success of CzechInvest is due to several factors:

- It acts as a one-stop-shop ...;
- each client is assigned a Project Manager, who concentrates on the individual investor;
- there is a clear-cut, standardized and formalized approach ... corresponding to different phases of the investment project;
- it handles contacts fully with authorities at the national and local level;

- it has a proactive strategy to lobby for important changes in the business environment;
- aftercare services ... and a forum are provided, so that foreign investors can communicate with the state administration and with Czech companies;
- there is an extensive domestic and international network of offices... and regional partners.”

Since the idea emerged of creating an investment promotion taskforce in 1990, and since CzechInvest was set up in 1992, the priorities of investment promotion have changed dramatically. The initial information service for FDI in manufacturing soon became specialized in promoting activities surrounding investments in automobiles, electronics and precision instruments. After 1997 the agenda extended first to the promotion of industrial zones/parks, aircraft industries, biotechnologies and medical instruments. After 2002 it shifted even more towards high technologies, technological centers, software, information and communications technology (ICT), human sciences, call centers, customer support and financial infrastructure. Under pressure from neoliberal opposition, it was plain that incentives should not be considered a replacement for a sound business environment by spoiling it with bureaucracy and corruption.

**FIGURE 2**  
**SIMPLIFIED ORGANIZATIONAL STRUCTURE OF CZECHINVEST, 2006**



Source: CzechInvest.org, 2006.

The organizational chart does not contain the division of internal services (ICT, accounting, human resources, internal audit). Neither does it list all departments (such as in the management of competitiveness or investment projects). The hierarchical subordination of units is not a characteristic feature of CzechInvest's management style. The interface with the national bodies of governance and the domestic private sector is through a steering committee that acts as an advisory institution. It has eight members representing the public sector and eight from the private sector. Its 2005 structure was as follows: MIT (chair), CzechInvest (two members), Ministry of Regional Development (two), Foreign Ministry (one), Ministry of Finance (one), Ministry of Labor (two); Chamber of Commerce (one), Confederation of Industry (one), Union of Cooperatives (one), Association of SMEs (one), State Guarantee and Development Bank (one), Association of Entrepreneurs (one) and Association for Foreign Investments (two). The latter institution, AFI, is of particular importance because it represents an interface with the domestic investment servicing sector and thus again with foreign investors.

In the period 1998–2007 (August) CzechInvest provided direct financial support to 776 projects investing US\$ 20 billion (34 percent of all FDI to the Czech Republic in that period), which created 153,000 new jobs (10 percent of jobs in Czech manufacturing). The cost of the public finance channeled via CzechInvest was US\$ 5 billion (including pending tax breaks). The incentives amount of amounted on average to 31 percent of the total amount of foreign investment into the core capital assets. In smaller projects the contribution was usually 50 percent. Large projects could end up with an incentive of about 15 percent. All of these were subject to EU ceilings on public support.

The priority categories for CzechInvest's selection of clients to support are as follows:<sup>9</sup>

- Type of investment/production (top-down ranking) —to R&D, service sector with high value added, manufacturing, other services, assembly operations.
- Value of the project.
- Number of new jobs created, ranked by the degree of skills.
- Region, ranked by unemployment rates.
- Development potential—importance of comparative advantages, potential for demand growth, level of demonstration effect.
- Technological level (ranked by the degree of the R&D requirements).
- Linkage capacity and the potential for spillovers (backward links to local firms; forward links to import substitution).

The weights of the above categories have changed over time. The quality of the investment project has risen in importance, while the significance of size and location has waned.

The categories of incentives granted by CzechInvest to foreign and indigenous investors cover the following areas:

- Job creation (by zones of unemployment).
- Land purchase from municipalities (often associated with the status of industrial zones).
- Infrastructure of all kinds.
- Employee re-qualification.
- Tax breaks up to the limit given by pre-defined ceilings on total public support. The tax break was therefore residual, not an automatic claim on all profits.

## A. Predicaments of the early period, 1989–1996

The main difficulty of the Czech economy in the early stages of the transition was to stabilize an economy that had been derailed from its historical patterns by command planning. The search for its new orientation in the world was an unprecedented challenge. Opening up to free trade after 40 years of autarchy became one of the first priorities, and the discussion about opening to foreign investment was a substantial part of that. Unfortunately, from the outset the discussion turned to revamping the existing state-owned enterprises that were organized as monopolies. It was somehow disregarded that an efficient market economy should be built from the scratch as greenfield ventures —in SMEs by local entrepreneurs and in large corporations by foreign capital. Hence privatization was in the forefront (Benacek, 2001a). There was an obsession with privatization to Czech hands —hands with very little capital and little experience selling on world markets. It was believed that salvation would come from

<sup>9</sup> The value of incentives is only loosely associated with these categories. They were generally determined directly by law without the requirement of personal negotiations (see next paragraph).

free markets guiding entrepreneurs to optimal solutions. Sales to foreign investors would follow by themselves once that solution had matured as optimally wealth-enhancing.

The dominant factor in the offshoring of the Czech Republic in the early 1990s was cheap labor. The average monthly wage in 1992 sank to US\$ 142 (it is now approaching US\$ 1,100). In the textile industry it was mere US\$ 100, while productivity per worker in modernized firms under the IPT arrangement was about 70 percent of the rate Italy or Germany (Benacek and Mejstrik, 1995). This is why the country was initially attractive for simple projects such as assembly lines in brownfield sites or booming IPT outsourcing. Unfortunately, both of them were highly footloose and the level of per-worker cash-flow that stayed in the country was extremely low.

The idea of creating an organization that could attract foreign investors could arise when the strategy of economic transformation based on private property was set up.<sup>10</sup> In 1990, three investment promotion organizations were founded. Their structure copied that of the Czechoslovak Federation, with one federal agency and two national ones. Nonetheless, before these organizations could start attracting strategic investors with a long-term vision, the separation of Czechoslovakia was decided in the 1992 elections. In November 1992, even before the “velvet divorce”, the Czech Republic and Slovakia separated their investment organizations, which in 1993 became CzechInvest and Sario, respectively. The separation gave more powers to the state while the earlier, spontaneous form of transformation from the economic grassroots was subjected to new policies applied by the government. Apart from for the Washington Consensus policies there were new social and industrial policies.

CzechInvest was created as an agency under the control of the Ministry of Industry and Trade. The relationship between CzechInvest and the ministry has been crucial to Czech restructuring thus far because this alignment has given high-level political support to industrial reforms. CzechInvest began as a small organization with unclear legal powers, a meager budget and few foreign experts. Its goal was to attract strategic foreign investors and thus to stimulate the Czech economy by means of additional investments and inflows of managerial skills. In the period 1992–1997 CzechInvest had no major programs to offer investors. Its main strategy was akin to marketing: promoting the advantages of the Czech economy and inviting investors to set up their businesses in the country.

According to J. A. Havelka, the organization’s founding CEO, the vital element that allowed CzechInvest to gain more influence was that it could use funds from the EU’s ACE/Phare Program. This led to the CzechInvest’s expansion, for example by setting up offices in important business centers overseas. EU funding accounted for up to 80 percent of CzechInvest’s budget. Though it may seem marginal, such financing also allowed the organization to hire two foreign advisors, one from Scotland and another from Ireland—that is, from two countries with highly developed programs for trade and investment promotion. For this reason all CzechInvest activities at the beginning were directed towards the British Isles.

Development projects associated with acquisition through privatization (that is, M&As) were exempt from the CzechInvest agenda. There were two reasons for this. First, these types of investments did not guarantee that any of CzechInvest’s objectives would be met. Neither job creation nor technological development were guaranteed by the M&As. Second, attracting an investor that was interested in such projects required complex information about the potential investing company and the company to be sold. CzechInvest had neither the capital nor enough employees to undertake this kind of project.<sup>11</sup>

CzechInvest’s design stressed its entrepreneurial orientation from the very beginning (since enthusiasm for and trust in personal initiative were widespread at that time). The idea was to run

<sup>10</sup> It is very interesting to compare this with the system of property rights in Singapore or, recently, in China, where entrepreneurship and profit-claiming are not in conflict with public administration, public ownership and public innovations.

<sup>11</sup> The need for an FDI promotion agency in the Czech Republic was apparent from the early days of the opening. Of all the transition countries, the Czech economy attracted the greatest among foreign investors. According to Howel (1995), to the end of 1993 there were bids for takeovers of US\$ 11.7 billion. Real commitments amounted to a mere US\$ 2 billion, while Hungary received US\$ 6 billion.

CzechInvest as an organization that differed from the prevailing stereotypes of public institutions, which meant having an effective structure, businesslike management, clearly defined powers, benchmarks for accountability to assess success and failure, a high level of moral probity among employees and an aim of targeting activities rather than “preferred” sectors. Another goal was to be as independent as possible, ideally to become a separate state agency with its own status under the law and its own budget, though autonomy would not exempt it from accountability to the ministry. This separation was never approved, but the level of independence (albeit informal) was very high, as was the level of political support from cabinet ministers. Independence from political pressure is crucial when an agency wants to react flexibly to its changing tasks and restructure its mechanisms accordingly.

In CzechInvest’s early years, training in economics in the country could not offer the human capital that the organization was looking for. Hence the staff hired were judged more on their personal performance rather than on their possession of diplomas. Once hired, staff were further educated in an in-service training program that focused on marketing rather than on economics.

During CzechInvest’s whole existence there were always those who argued that it should not be a public organization but that it should work as a private entity. Or that it should be replaced by a *carte blanche* for all private businesses ready to act as investment promoters. Experience shows that there were reasons why this would not be a good arrangement. CzechInvest’s goal was always to attract companies that were in their final phase of deciding in which country to settle. Why should foreign companies pay for support when they did not have to do so in other countries? The second reason was that a private investment intermediary would face a conflict of interest whenever some government priority impinged on its profit from intermediation. For example, how should the agencies be paid for promoting investors that created large numbers of jobs, that located in regions with high unemployment, that targeted projects with certain levels of spillovers and demonstration effects? Such schemes could be designed, but some state institution would always have to oversee it. In the end it would have to be CzechInvest again that could mastermind these schemes, which actually happened later when incentives and criteria were firmly outlined. Then private agencies could compete for contracts with foreign investors when CzechInvest could outsource such operational activities.

In the mid 1990s CzechInvest did not have any general scheme to support foreign investors, but there was a minor project called the Hosting Program. This was to invite representatives of multinational corporations (MNCs) to the country in order to offer them a presentation on the economic situation and investment procedures, and to recommend potential projects to them. This program was meant initially for overseas companies, particularly from the United States and Japan, which were thought to be less informed than European investors.

The 1990s was a period of building credibility and of stabilization. FDI considerations hinged on a belief about whether the Central and Eastern European countries (CEECs) would or would not become solid parts of the European (or even the world) economic order. Most investors had doubts about it. For example, Howell (1995: 106) asserted that “there are only limited possibilities to improve return on capital employed in eastern Europe. The restructuring of companies takes an enormous time and pay-back will never reach the ratios we obtain through UK and US investments.” Clearly, it required much effort to persuade investors with similar advisors that the opposite was true in the Czech Republic.

Contrary to judgments that markets provide all information and private businesses are always able to recognize optimal solutions, imperfect information about local markets and enterprises was the main obstacle to be overcome. It was difficult to assess the performance of domestic firms since they had no business history. Ever changing national laws were idiosyncratic and opaque, and the uncertainties of investors exposed them to high risks. Lending and investing acquired the features of speculation, when redistributive motives took primacy over productive goals. Thus the existence of state agency with similarly imperfect information but with a commitment to take guarantees (which a private company or a bank could scarcely do at the time) was an important step forward.

Foreign companies were thus offered a contact institution so that they could first test the country through simpler projects. Most of the time it was not possible to offer incentives. The pilot trial program was launched in 1997. CzechInvest's most successful project, because of its demonstration effect, was the Matsushita/Panasonic initiative that was set up in 1996. This Japanese project was supposed to target Poland, thus replacing production in Cardiff, Wales. But an offer from CzechInvest persuaded the investor to enter the Czech Republic. Interestingly, and notwithstanding the policy of no incentives, the breakeven point came when CzechInvest found a way to secure some tariff relief for Matsushita's imports of material and when the Czechs promised to expedite the construction of the highway to Germany.

## B. Speeding up, 1997–1999

The 1997–1999 period was highly successful for the development of industrial policies and CzechInvest, even though the economy was affected by a slump caused by unstructured state banking on the verge of bankruptcy, unsettled contract enforcement laws that spurred too many firms to rent-seeking, and the need to abandon specialization in labor-intensive products. There was a demand for new last-resort policies and reliance on foreign capital became a priority. Thus CzechInvest could launch its long-prepared strategies, including investment incentives.<sup>12</sup> Later, these activities were accorded international recognition, placing CzechInvest among the world's leading investment agencies in the world. In this period, incentives were widely supported by politicians and the public.<sup>13</sup>

The Czech economy finally earned credibility among foreign investors and the country was bound for an investment boom. Investors realized, once they could handle simple projects in the Czech Republic, that there was state support for much more sophisticated ventures. Their perceived risk of investing declined sharply. Moreover, the Czech Republic's comparative advantage from the start of the decade, which was in cheap labor, began to wane and was gradually replaced by specialization in more stable capital-intensive technologies supported by more educated labor. Foreign investors soon became the main customers of local banks, and in 1999 they accounted for more than 50 percent of national investments and exports. They switched strategies and included broader local outsourcing in their plans, which stimulated backward spillovers. CzechInvest responded with policies to support the building of new networks in local industrial and technological parks.<sup>14</sup> The formation of clusters eased quality upgrading in their product mix and facilitated the introduction of new technologies.

Czech FDI promotion schemes were significantly influenced by the Irish experience. According to Tomáš Hruša (CEO of CzechInvest in 2005–2006), CzechInvest's employees were often sent on internships to all three Irish agencies that were considered the best strategic entities in the art of building competitiveness. But this cooperation declined when the Czechs became able to follow their own strategies and when the results made CzechInvest a competitor to Ireland.

Up to 1999, FDI was not characterized by any set of “preferred industries” at which FDI would be targeted (Benacek, 2001b). Though large amounts were directed at services, real estate and energy, FDI was clustered to a large extent around the automobile industry. This pattern was in line with the observation

<sup>12</sup> These strategies are described further below in Section 3.1 on the Investment Incentives Act.

<sup>13</sup> It is not without irony that a country whose rhetoric expressed the greatest loyalty to the Washington Consensus, and which spent seven years resisting any preferential treatment for its “external orientation”, suddenly became a champion of industrial policies. According to Rodrik (2004: 29) “industrial policies have run rampant during the last two decades—and nowhere more so than in those economies that have steadfastly adopted the agenda of orthodox reform.”

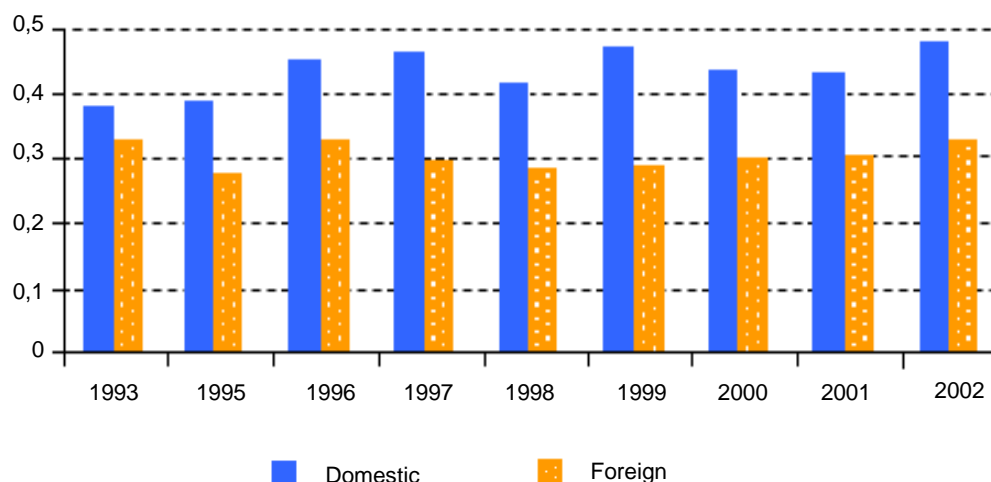
<sup>14</sup> The effort to put the Czech Republic on the map for potential investors in large, high-tech ventures peaked in 1999, when the Philips project in electronics was under preparation. Philips decided to relocate its production of VDUs from Western Europe and invest €R 200 million in the Czech Republic by receiving an implicit subsidy of CZK 1.5 billion (€ 43 million) to create 3,250 new jobs. Seven years later this project collapsed when the mother company in the Netherlands declared bankruptcy and the employment decreased to 900. According to the contract, half of the incentives had to be returned. However, this liability rose to € 28 million because of the appreciation of the koruna while the company fell into insolvency. Thus far the legal battle has not ended. Nevertheless, this venture was one of the rare cases (of the total of 800) when the Czech incentive scheme fell short of expectations.



of Imbs and Wacziarg (2003) that a growing underdeveloped economy expands by intensive trading and its pattern of specialization becomes more diversified. In the enterprises where foreign capital was invested, there was a bias in switching from labor- to capital-intensive industries and labor-saving technologies. Their capital and labor efficiencies have been significantly above the domestic average (Benacek, 2001b).

Another salient feature of the FDI enterprises was that they were very export-intensive and, on the input side, they had a higher proportion of material inputs (coming mainly from imports) and thus a relatively lower proportion of domestic wages in final output (see Figure 2). The proportion of gross profits (often hidden by transfer pricing) on value added was then unusually high, much higher than in the EU-15. Most of the FDI commitments were directed at industries with intensive intra-industrial trade, whose share of exports soon rose to West European standards. They also showed high investments per unit of output that were at least double of that in local firms. If combined with the higher human capital in foreign firms, attracted by their significantly higher average wages, it was clear by 1998 that future Czech growth would continue to be driven by firms with foreign owners. At the same time, before 2000, few FDI commitments were geared to high-tech industries and greenfield investments. In the case of investments in high-tech industries, foreign enterprises had a tendency to concentrate on assembly operations from imported high-tech materials and not on local R&D and human capital. This was a clear message for improvements in CzechInvest policy-making at the turn of millennium.<sup>15</sup>

**FIGURE 3**  
**SHARE OF GROSS WAGES ON VALUE ADDED IN CZECH MANUFACTURING**  
**IN DOMESTIC AND FOREIGN FIRMS**



Source: Author, based on official numbers.

It was a recognized principle of CzechInvest management that the contact with private enterprises was exercised directly and kept free of rent-seeking (see also Rodrik, 2004). Since the private businesses were not coordinated in their joint action, CzechInvest agreed that they form the Association for Foreign Investments (AFI). Membership of AFI is offered to Czech and foreign firms provided that three existing members volunteer to sign an affidavit guaranteeing their quality and the member pays membership fees. The membership is composed mainly of enterprises with local experience that support the entry of foreign investors into the Czech economy (many of them are consultancies, IT and HR companies) and offer a wide range of

<sup>15</sup> There were other indications in the field studies that pointed to the need for new CzechInvest policies. The economy could improve significantly if local firms were more flexible in imitating the management patterns and technologies of firms with FDI. The widening gap between local and foreign firms had to be reversed. Local firms should also affect another, less encouraging feature: the tendency in large FDI enterprises to use local market power in controlling domestic sales and market entry.

professional services to foreign investors entering the Czech market. CzechInvest and AFI established a common project “Partnership to Support FDI.” AFI is managed by a steering committee that has nine members

AFI has organized four thematic field studies, on investment incentives, industrial property, employment and human resource development, and public/private partnerships, whose aim is to lobby for a more efficient investment climate in the Czech Republic. It offers schemes with suggestions, case studies of good practices and specific solutions geared to improving the quality of legislation and administrative procedures. Foreign investors thus have an institution that can represent their collective experiences and political interests, one that is free of particular entrenched interests.

The problem with AFI is that its members have privileged access to foreign investors. Some non-members and non-governmental organizations (NGOs) protest that it creates unequal standing in the competition to service foreign investors. AFI members have even earned the nickname of “comprador servicing sector” (Franc and Neshyba, /2007). Perhaps the membership should be less restrictive, though it would downgrade the present elite structure of the association and thus make it less flexible in its decision-making.

## C. Innovation strategies, 2000–2003

The period 2000–2003 marked a new horizon for CzechInvest policies. The Czech economy was stabilized after the second post-privatization shock (1997–1999) during which time the gap between the deeply restructured export-oriented enterprises and the local firms engaged in the production of non-traded commodities widened sharply. A dual task arose: to support further the strong players through export promotion, and to promote the penetration of spillovers from internationally opened foreign enterprises into the indigenous sectors. The main vehicle was in the restructuring and privatization of the financial (banking) sector. Restructuring the failing capital market (stock exchange) was another spin-off associated with privatization that generally failed. While stock exchanges in Britain or the United States provide market capitalization of over 100 percent of GDP, the five most important stock exchanges in Eastern Europe (Warsaw, Prague, Budapest, Ljubljana and Bratislava) provide much less than 25 percent, even though some of them were established as all-embracing hubs.

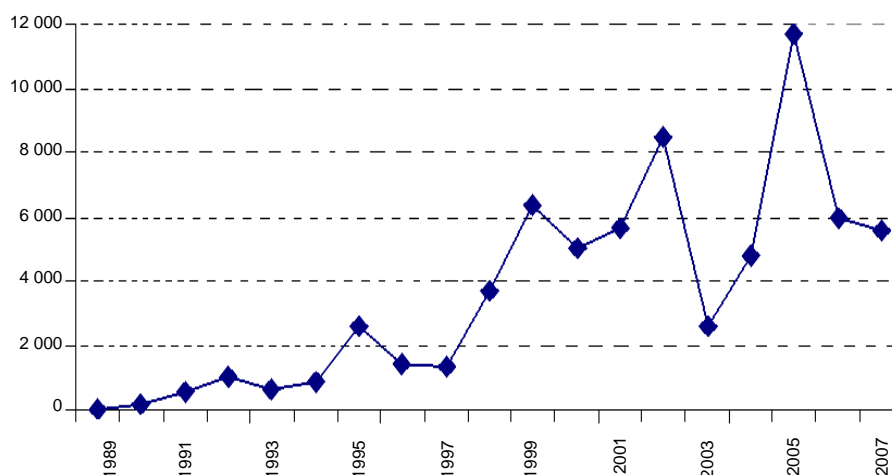
Though CzechInvest was not selected as an executive agent for these sweeping changes, its supportive role was no less important. The cooperation between banks, capital markets and enterprises is crucial in modern economies because these depend on transactions sheltered by risky contracts over long periods of time. Such contracts are not self-enforcing. Governance in the financial sector before 1997 revealed that its main incentive was opportunism and predation, the spillovers of which into the enterprise sector were the weakest link in Czech development. As mentioned earlier, explicit and implicit transfers from the public to private sector could reach US\$ 74 billion (valued at PPP and cumulated for 1991–2004). The access of privileged insiders, representing a tiny part of businesses, to such riches (compared to the GDP of US\$ 148 billion in 1999) was definitely a poor incentive for prosperity in the productive sector. Defaults of such an order scarcely have a parallel in developed market economies during peacetime. Note the paradox that almost the total value of assets privatized under the non-traditional schemes (such as the voucher scheme) was counter-balanced by debts, the residuals of which are pending even today to be bailed out by the public finance.<sup>16</sup> In 1999 it was clear

<sup>16</sup> For example, as Czech commercial banks became the main intermediaries in privatization schemes, 34 percent of their loan portfolios in 1998 consisted of classified credits (21 percent of GDP). In some other countries the peak came in 1999, when the share of bad loans in total loans was 40 percent in Slovakia and 37 percent in Romania, while it was only 3 percent in Hungary and Estonia and 15 percent in Poland (World Bank, 2000). The bailout of the Czech banking sector was the main component of the government’s subsidy program. The Ministry of Finance estimated its costs at CZK 578 billion (about US\$ 17–22 billion at the commercial exchange rate). Various subsidies and bailouts paid by the other state institutions (such as the National Property Fund, the Czech National Bank and so on) are excluded from these estimates of “implicit subsidies”. We can estimate that altogether the value of bad debts, defaults and contract breaching (i.e., including unpaid deliveries among enterprises, wages, social and

that the time called for new policies that could open niches of missed productive opportunities in the private sector. The entrepreneurial spirit that came with FDI, and which could spread to the whole economy, was the target of such policies.

After helping to establish several greenfield projects with a lower technical level in the late 1990s, CzechInvest's policies had to be restructured again. The aim was to attract FDI with more progressive technologies and higher spillover effects, so that the country could catching up. An important impulse for CzechInvest came in 2000 when the European Commission and the European Council decided on the Lisbon Strategy. The plan was to transform the European economy into "the most competitive and dynamic knowledge-based economy in the world." Now, seven years later, we can doubt whether this type of a "planning by decree" was a viable idea, especially when the European Commission is an institution with a weak command of instruments that are located on national levels.

**FIGURE 4**  
**FDI ANNUAL INFLOWS TO THE CZECH ECONOMY**  
(US\$ millions)



Source: Czech National Bank, Balance of Payments, 2007.

The Lisbon Strategy, however, represented a guideline for CzechInvest. The goals of Lisbon became compatible with the new national objectives:

- Supporting the knowledge-based economy;
- enhancing the space for more efficient R&D;
- speeding up the design of a new economic development strategy;
- pushing the structural reforms for competitiveness; and

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healthcare benefits, taxes, etc.) was about 50 percent of GDP in 1999. If valued at PPP, such explicit and implicit transfers from the public to private sector could reach US\$ 74 billion (valued at PPP and cumulated for 1991–2004). The access of privileged insiders, representing a tiny part of businesses, to such riches (GDP in 1999 was US\$ 148 billion) was definitely the wrong incentive for prosperity in the productive sector. Defaults on such a scale have barely a parallel in developed market economies during peacetime. Note that nearly the full value of assets privatized under the non-traditional schemes (such as the voucher scheme) was counterbalanced by debts that even today are partially pending to be bailed out by public finance.

- investing in people.

The most palpable improvement was the adoption of the Investment Incentives Act. Moreover, several new programs were launched in this period. Because of this and CzechInvest's neutral political stance as an intermediary between public and private interests, the political scene supported new industrial policies and many high-quality foreign projects were attracted during 1999–2002 (see Figure 4). The growth that accelerated in 2004 had its roots in these institutional changes.

## 1. The Investment Incentives Act

The most important policy of this period from CzechInvest's viewpoint was the adoption of the Investment Incentives Act. There were two reasons for this. First, Czech society had been subject for too long to informal networks and its corporate culture suffered from a lack of formal processes. Hence the need to create a universal framework based on explicit rules that could be binding on both parties—all FDI agents as well as their domestic partners—so that every company would face the same conditions. Universally valid rules also eliminated attempts at discretionary (“case-by-case”) negotiations at the level of the central and regional governments. Their transparency relieved the state from interventions and offered space for private agencies to become involved, while the government retained its strategic political oversight in the role of principal. CzechInvest was thus empowered as its coordination and deliberation agent. Second, as more foreign companies were motivated by safeguards in the enforcement of property rights to establish a business in the Czech Republic, the government was no longer able to deal with every single incentive alone in an appropriate way.

By cutting ministries' embeddedness with the operational FDI agenda of accession and vesting these activities in an agency with demonstrated competence accountable to the MIT and the government alone, the scope for corruption was minimized while strategies could still be very flexible and the channel for information between private and public sector actually widened. According to Rodrik (2004), these conditions are crucial for sound central decision-making.

According to J. A. Havelka, the idea of offering investment incentives had been maturing in the CzechInvest steering committee since 1994. In 1991–1996 the Czech Republic suffered because neighboring countries used such policies and CzechInvest lost many projects because it could not offer a matching proposal. At that time the government backed the policy of non-intervention on FDI, though there were policies supporting national investors<sup>17</sup> and the voucher scheme excluded foreign investors from direct privatization. CzechInvest proposed that the government launch an outward-oriented incentive program, but without success.

In 1997, after the government crisis, outgoing Prime Minister Klaus finally agreed to launch an incentive policy and ordered CzechInvest to prepare a pilot scheme. Nevertheless, the government was unwilling to allocate it substantial funds because support for local businesses remained its higher priority. The 1997–2000 period was just a trial period phase when CzechInvest was already entitled to select and sign contracts for incentives. On the basis of that experience, CzechInvest's task was to design a multifaceted scheme that would balance foreign and national interests and would also become self-sustainable. The interests of all parties involved—investors, sellers, potential suppliers and the approval and intermediation institutions—were supposed to find equilibrium among themselves while CzechInvest acted as a coordinator and intermediary of last resort. The tricky thing in designing such a legal scheme was to make it neither too generous nor too modest and discouraging. The other balance

<sup>17</sup> The policy of the “Czech way” of privatization came to fore as the second wave of the voucher scheme was close to completion (1995–97). The giant iron and machinery estates of Skoda Pilsen, Tatra trucks, Poldi steel and CKD industries—whose only assets were in their skilled labor and which evidently could not survive without being part of worldwide marketing networks—were offered to would-be grand national entrepreneurs who did nothing but bring them to bankruptcy. The objection that foreign investors did not offer a “sufficient price”, abusing their monopolistic power, is not valid because it was evident that the real market price of such behemoths was most probably negative. That is, a subsidy should have been offered in order to “sell” such companies. The question therefore was how to calibrate the rules of “marketing” such unavoidable subsidization schemes. The “incentive schemes” became an optimal solution.

concerned the bureaucracy. The losses from not reaching the “optimal” incentive by additional negotiating were offset by dismantling bureaucracies of “compliance costs” that otherwise burdened both parties. Additionally, greater transparency brought externalities that a private investor was unlikely to generate, such as investments in infrastructure, upgrading labor skills or better communication with regional governments. It was evident that this prerequisite would not be satisfied for small projects. Hence there was set a limit on the value of investment: originally US\$ 50 million, lowered in 1998 to US\$ 25 million and in 2000 to US\$ 10 million. Since 2006 the threshold has been US\$ 5 million in order to eliminate discrimination against SMEs, which otherwise would be unable to access incentives.

The trial period was launched because CzechInvest believed that the Act has to be based on the national experience and not just copied from abroad. Although the new laws and their enforcement mechanisms were accompanied by much heated political discussion, the Act was approved in the Parliament almost unanimously. This means there was a strong national consensus about new policies—a “detail” that was crucial to the Irish economic miracle. The Investment Incentives Act came into force in May 2000, setting a clear structure for procedures, claims and liabilities on all parties negotiating the entry of FDI.

The Investment Incentives Act supported companies that invested in a project US\$10 million or more with the following types of incentives:

- Corporate tax breaks with strictly stipulated conditions and duration;
- subsidies subject to the number of jobs created and the priority geographic areas;
- subsidy for re-training and educating employees;
- advantageous prices for the purchase of land.<sup>18</sup>

The limit of US\$ 10 million was questionable. Current President Klaus (2002) objected that though the Act was formally fair for all applicants (foreign and domestic), the limit discriminated against Czech investors, whose access to capital was allegedly more limited. Martin Jahn, former CzechInvest CEO and later the Deputy Prime Minister responsible for investment promotion and economic reform, defended the law by stating that in 2002 Czech companies took part in 8 percent of the investments with incentives, which was quite high considering that some foreign projects amounted to hundreds of millions of dollars (Jahn, 2002). Altogether, 18 percent of all firms receiving incentives were Czech. This shows that Czech firms were significantly less oriented to expansion and innovation than foreign firms.

Having an unambiguous general law giving the same opportunities to all has advantages and disadvantages. The first disadvantage is a problem of fixed rules, where one “size” does not fit all. There will always be a project that would pass only if there is a little more flexibility in negotiations. Thus the law should be structured to allow for sufficient flexibility, especially if countries in the neighborhood have no such constraints. For example, granting corporate tax breaks (or a full tax holiday) when Czech law sets a cap for Czech negotiators (while a Hungarian competitor has no such limit), the negotiations become a game in which the Czech side is playing with its cards visible while the other players keep them hidden.

According to T. Hrudá, the greatest advantage of such a universal system based on clear rules was its transparency. Suddenly the transaction costs of negotiations fell sharply on both sides. There was no need to bluff and little scope for corruption. A company interested in investing in the Czech Republic received clear information about what support it could obtain in a certain region and on which conditions. There was also a certainty that no other company would obtain significantly better conditions and out-compete the first mover merely by opting for a lower subsidy. The prestige a country acquires from functioning laws, a disciplined public sector and a low level of corruption is an important incentive to invest and has a significant spillover effect backing entrepreneurship.

<sup>18</sup> Until EU accession, the acquisition of land and real estate by foreign entities not registered in the Czech Republic was strictly regulated.

From the adoption of the Act in 2000 to September 2007, only two projects were granted government exceptions (with practically negligible adjustments) because of their complicated links to other parts of the economy. These were the TPCA (a joint venture of Toyota, Peugeot and Citroen) and Hyundai projects. Some experts presume that the Investment Incentives Act was the main factor in attracting investments into high technology after 2000. That year was a watershed when the Czech Republic, which until 1991 had resembled Argentina or Mexico, started to compete on world markets for high-tech goods and information and communication technologies. A recent study by the Accenture think tank (Accenture, 2007: 26) says that the Czech Republic, despite its small size, is the fourth most attractive European country as a destination for R&D investment. Note also the view of Nobel laureate Edward Prescott, who is a leading specialist on economic capital. In an interview during a study tour in Prague (Hospodarske Noviny, July 7, 2007: 21) he said that the Czech Republic was poised to become a key financial hub in Central Europe because of its leadership in e-banking and the ability to penetrate world money markets virtually.

Another highlight of the Investment Incentives Act (a real innovation in Central and Eastern Europe) was the compatibility of its standards with those of the EU. The Act was discussed with the European Commission in its early stages and anticipated future EU criteria for the provision of public aid. Hence the toughest conditions were applied from the very start in 2000, and no change was needed for accession to the EU in 2004. All investors had a guarantee that their incentives conditions concluded before 2004 would not have to be revised downwards, an assurance that some other accession countries could not guarantee.

## 2. Shift in the structure of investments

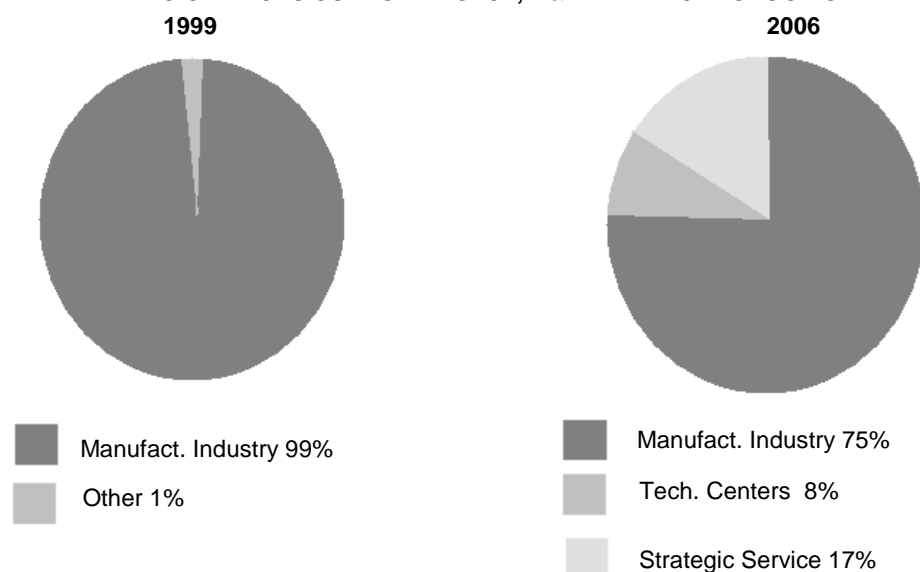
With the implementation of the new act, new investors were attracted to the country and the quantitative trend that began in 1998 persisted. Now, however, it would be more relevant to talk about the quality of projects rather than their quantity. There was a marked shift in CzechInvest's treatment of manufacturing. The shift was from investing in standard technologies for mainstream manufacturing or labor-intensive industries and towards capital-, property- and technology-intensive production. Thus there was a shift to investing in production associated with services requiring R&D inputs, university education or alignment with technological parks (see Figure 5).

The most relevant information is that CzechInvest's new strategies avoided the liability of traditional industrial policies that were biased towards "hand-picking winners" (which often amounted to picking losers) or marked by a desire to target "preferred industries," with the risk of hurting the strong by supporting the weak. The new policies were based on supporting the buildup of endowments that gave modern technologies a natural comparative advantage. Thus the concentration was on activities and projects to support the processes underpinning the high-tech rather than on supporting concrete industries.

The Czech economy became so attractive to investors that CzechInvest found itself in a position of choosing among proposed projects and thus preferentially supporting (above the standard services emanating from the Act) only projects with a high potential for spillovers. There was a to introduce other schemes that were not associated directly with any concrete investors. As a result of these initiatives, Government Resolution 573 went into effect in July 2002. It addressed the requirements to facilitate investment in software design, information technologies, innovation and production development, customer support centers, shared service centers and research and consultancy centers. The pilot project for this new strategy was an IBM venture in Brno. Although small Czech software firms were successful before 2000, they were not internationally recognized and were not targets for international takeovers. With the success of IBM, foreign investors' attention to Czech ICT increased markedly.<sup>19</sup>

<sup>19</sup> Together with the Honeywell research center in software, information and communication technologies, and the DHL network coordination hub, the IBM Global Services and IBM Integrated Delivery Center became flagships of new CzechInvest strategies after 2004, when support for investors in the automotive sector was downgraded. Indeed, further investments in medium high-tech or intermediate technologies in the manufacturing sector were not considered a sustainable strategy, once Czech production of automobiles reached a potential capacity of 2 million cars. IBM now

**FIGURE 5**  
**THE STRUCTURE OF MANUFACTURING INVESTMENTS CLASSIFIED BY THEIR RELATIONSHIP**  
**TO SERVICES SUPPORTING ICT, R&D AND TECHNOLOGIES**



Source: CszechInvest.org

### 3. The supplier development program

It is important to analyze the impact of FDI on the Czech economy. One of the most important factors in this area is cooperation between foreign companies and Czech suppliers. Czech suppliers have often complained that investors do not bring a net benefit to the country because they simply replace existing local businesses. Naturally the problem was to analyze who was replaced and by whom. Was it an incoming firm with high potential ruining a firm with low potential or the other way round? The former type of competition should be encouraged. CzechInvest also contacted the World Bank and asked for expertise on supporting local firms, especially if they could develop into strong outsourcing suppliers and thereby complement the business leaders. Another problem was how to improve communication between local companies and MNCs. The bottleneck of Czech suppliers, as suppliers for a small market, was their inability to supply MNCs with a sufficient volume of components. Because of the lagging scale economies, initial offers were often judged as non-competitive in price.

Incoming foreign companies retained their original input supply chain even though the intermediate products had to circumnavigate the world. For example, Panasonic originally bought only 5 percent of its inputs on the Czech market. The problem was in stalled information channels and a strong foothold at least in the local market. To bring about progress, the Supplier Development Program was launched in 1999 with the support of the EU Phare Program and cofinanced by the Czech government. It was based on several policy instruments.

First, the Supplier Development Program concentrated on heightening the quality of local producers. It was important to make them a part of a global leadership. If domestic firms could not

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employs a staff of 2,000 engineers in the Czech Republic for outsourcing information technologies. They work for more than 500 corporate clients all over the world. The consultation business requires communication in 70 languages.

become global champions, then policies of affiliation with strong foreign partners could be an alternative. Surprisingly, as was discovered later, MNCs also needed to become “local” and to have reliable local partners. The first step was that CzechInvest provided for the evaluation methodology of the European Foundation for Quality Excellence. Once the benchmarking was set, the gaps between Czech suppliers and foreign competitors were revealed, which facilitated imitation to level the quality.

In the pilot scheme launched in 2000, the idea was to match 45 Czech electrical and electronics firms (selected from 200 candidates) with 11 MNCs operating in the Czech Republic and willing to optimize their supply chain. After two years more than a half of the participating Czech companies had become suppliers of MNCs and the share of local input in the sector had risen by 21 percent, according to KPMG estimates (see also OECD, 2006: 65).

The program also enabled local firms to remain in contact with potential customers among MNCs even after the scheme ended. The idea was to motivate both partners to cooperate and potentially bear the costs of innovation. This was the goal of the second policy of the Supplier Development Program. It aimed to ease communications between MNCs and local suppliers by means of a large internet database of suppliers' offers, which MNCs could easily search for information about establishing a joint venture. Without the benefits of the economies of scale generated by the government's coordination and financing, individual firms would be unlikely to enter into a venture in which they bear the costs while the benefits are uncertain. As this program developed, the database was divided into three sections according to different users: the General Supplier Database, the Automotive Supplier Database and the Aerospace Supplier Database. In 2006, two more separate databases were prepared, one in the field of IT and the other in the area of electronics.

The third instrument used in this program is Financial Intermediation for Business Expansion. The problem is not the lack of finance but the credibility of the business plan. The risk of default is mitigated when CzechInvest can provide an affidavit to a lending bank or when even the MNC as a partner can guarantee the contract for supplies.

To assess the performance of the Supplier Development Program we can look at the data on signed partnership contracts. In the period 2001–2006, partnerships worth US\$ 250 million in new contracts were signed. Table 1 shows the spread over particular sectors. The annual gain in contracts for US\$ 50 million might look too low compared to a US\$ 7.7 billion average annual increase in the export sales of Czech FDI firms. But in fact it brought a large benefit compared to the very low public cost of running this free service.

**TABLE 1**  
**INVESTMENTS OF SECTORS SUPPORTED BY THE SUPPLIER DEVELOPMENT PROGRAM 2001–2006**

Sector	Volume of contracts in US\$ millions
Plastics	80.8
AC components	58.4
Engineering	56.1
Electronics	25.5
Car Industry	21.5

Source: Supplier Development Database, 2007.



## 4. Industrial Zone Development Support Program

The EU cohesion funds demonstrated that there was a close link between attracting FDI and the development of transport, energy, education and communication infrastructure. The costs can be reduced and the externalities increased if the infrastructure is concentrated in industrial zones. At the beginning, the number and the quality of industrial zones built on the initiative of local councils fell short of foreign investors' requirements. Coordination was needed, which CzechInvest undertook to mediate in 1998. The objective of this program was not only to attract more FDI but also to create more jobs in economically less developed regions by combining foreign and domestic investors in a place that would be ready for the immediate entry of investors.

The program required government finance that was originally used for building the local infrastructure and buying land. It could be argued that private investors could do the same or even better, especially when the investors are certain and the site could be sold to them. But industrial zones as a promotion program must be built without knowing who will come to them as investors. The risks in underdeveloped regions are too high for private investors to invest enough to prepare a high-quality site. If the investment is made with the help of local governments and coordinated at the national level, the risks are spread over a range of projects and the state and municipalities are motivated to reduce the bureaucracy for the entry of investment.

In 2002 the program was upgraded in order to give benefits especially to projects in which an investor had already been found through the Investment Incentives Act. The idea was to re-direct the intentions of investors from locating on a virgin greenfield to taking over an already prepared site and purchase it at a discount. Another upgrade of this policy concerned the reconstruction of brownfield sites through the Industrial Zone Regeneration program. In 2003, CzechInvest started to stress the participation of domestic private firms in the industrial zone projects. Its policy was to coordinate the partnerships between public and private investors and to cover the cost gap.

Altogether 92 industrial zones covering 2,131 hectares were supported during 1998–2005 at a cost of US\$ 225 million. These projects attracted 357 enterprises that invested nearly US\$ 6 billion and created 72,000 jobs. Not all zones or parks were built with CzechInvest support. Many were established by private developers because the initial economic success of similar projects lowered the risks of such ventures and incentives from the central government became unnecessary.

## 5. The AfterCare program

Many FDI projects after 1999 were reinvestments of profits from the previous presence of these foreign companies in the country. Repatriation of all capital outlays with an accelerated depreciation scheme, including an implicit interest return hedged by a risk premium of at least 15 percent, is standard procedure. This is in addition to standard profits from running the business. It means that FDI must be treated as an expensive credit to the host country, which will burden its balance of trade in the long run. For this reason it is a good strategy to motivate settled investors to keep their business in the country. That means the local long-term yields should be kept high enough to out-compete all alternative investments discounted for their risks. Thus it would pay to support even settled foreign investors in making their ventures highly profitable. The working contact between the government and the investors should not cease after the business is settled. Then there are new chances of implementing additional national interests in the company's policies, or increasing the spillover of externalities from foreign companies into the national economy.

In 2001, all these reasons prompted the establishment of the AfterCare department as a separate body in the CzechInvest organization. In 2003, the department was relocated and became a section of the Investment Support Division. Its aim was to look after projects that had already been established in the country, support them in solving their conflicts with administration and foster their expansion. The latter was to be done by providing companies with consulting services, supporting their contacts with schools

and universities, encouraging their cooperation with local public institutions, and proposing draft laws to improve the country's business environment.

The Human Resources Management Unit was set up within the AfterCare Program. One of its goals is to provide companies with skilled labor by stimulating local educational programs and cooperation between companies and schools. It should also help companies obtain work permits for foreign workers outside of the EU. An aim of crucial importance is to support the company's demand for more workers with high skills so that all local resources are fully used.

A study by Stejskal and Charbursky (2005) helps us assess the effectiveness of AfterCare. The survey covers 31 foreign companies that invested in the Czech Republic and the results are not particularly encouraging: only 61 percent of the companies interviewed knew that the AfterCare program existed and only a half of them made contact with this program. At the end, only 7 of the 31 companies wished to be visited by an AfterCare representative. Though the number of enterprises involved in the survey was somewhat low, it can be assumed that not all CzechInvest programs hit the bull's eye. There is an important rule in policymaking: there should be a built-in sunset clause for cases when something does not pay off for some time, notwithstanding the excellence of intentions.

## 6. The TPCA acquisition

Attracting the TPCA (Toyota Peugeot Citroen Automobile) venture, one of the world's most innovative and aggressive companies in the car industry, was a large project for CzechInvest. Its importance lies in the coordination between private and public stakeholders that would otherwise entail prohibitive transaction costs for the entrant. It means moving thousands of workers from their present jobs. In addition, since 2006 an even more ambitious Hyundai project has been under construction and, close to it, KIA has just finished a similar complex in Slovakia. The region of the four Visegrad countries (the Czech Republic, Slovakia, Hungary and Poland) is forming a car agglomeration that will soon produce 3 million private cars a year and around which there are concentrated hundreds of mushrooming suppliers of components and services supporting the production and the use of cars. The problem for government coordination is that such a concentration of one particular industry is a risk for the whole economy once the demand for cars is hit by a shock or if the producers decide to move eastwards in search of cheaper labor.

The government's industrial policies can vary a great deal. They can promote the education and re-skilling of the unemployed so that factories are not forced out of the country because of vacancies and rising wages. They can liberalize the immigration of workers from abroad, such as from Ukraine. labor market pooling is a positive aspect of migration, as are the expected knowledge spillovers. Coordination should take care that the clusters benefit from the greater contestability rather than being adversely affected by it.<sup>20</sup> In the end, therefore, agglomeration will give rise to the most efficient workers in this part of the world and their increasing wages will remain highly competitive. Another task of coordination concerns supply chains. Agglomeration continues to expand if its transaction costs are declining such that local outsourcing is profitable. The most efficient agent in keeping transaction costs low is the government.

Another aspect of industrial policies is the move away from commodity production, especially if natural resources are not local comparative advantages. Instead of concentrating on car assembly, policies should target its spillovers into support services: to R&D, software, information and communication channels, schools and providers of specialized equipment. An aim is that, in the long-run, no global player in the car industry should ignore cooperation with this Central European agglomeration. Moving away from it could be also risky: producers in the broader region would not be able to find a cluster with greater externalities for their relocation.

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<sup>20</sup> Fears that the competition of four new car producers in the region will squeeze Skoda (the largest car producer in the country, with production of nearly 700,000 cars and a workforce of 27,000) out of the market or make its production unprofitable do not seem justified. Skoda's profits have increased proportionally with the rise in competition (from € 180 million in 2004 to € 600 million in 2006), and its production plans have expanded.

In 2002, therefore, CzechInvest established a special taskforce to attend to the TPCA agenda. At the time it was obvious that the construction of a new automobile cluster in Central Europe could be close, provided the policies do not give a cold shoulder to future winners. The TPCA project could follow the opportunities offered by the Investment Incentives Act. The only government exceptions concerned the intermediation and guarantees for the buy-out of land from more than 100 private owners to offer more advantages for TPCA. Additionally, there were municipal pledges on infrastructure and an employee program. These commitments were balanced by matching guarantees from TPCA about their presence in the Czech Republic.<sup>21</sup> Hrudá, the leader of this project in 2002, says that TPCA was then the biggest project facilitated by incentives in the Czech Republic. The TPCA team had to cooperate with other departments, especially the Supplier Development Program and the Industrial Zone Development Support Program.

In March 2007, the TPCA endeavor celebrated its fifth anniversary in the Czech Republic. It produces 300,000 vehicles a year, signs US\$ 1 billion in contracts with its suppliers (Czech suppliers are in first place), and has a turnover of US\$ 2.5 billion a year. The dual entry of this prestigious producer (TPCA-Kolin was a twin investment with a venture by Trnava/Slovakia) gave a clear signal to other investors in the cars and components sector that settled in Poland, Slovakia and Romania. The € 850 million arrival by TPCA was followed by a € 1300 investment from Hyundai.

## **7. Rules applied at the end of the 1990s for ranking CzechInvest priorities**

- 1) The level of technological sophistication, which is reflected by high wages.
- 2) Type of production, ranked from the top down:
  - R&D applied to one's own production or sold to international clients,
  - exported services (e.g. consultancies, call centers or forwarding hubs),
  - manufacturing based on high technologies,
  - assembly operations.
- 3) Value of the investment project and the guarantees of its long duration.
- 4) The number of new jobs created, subject to sophistication.
- 5) Regional aspects ranked by unemployment rates.
- 6) The potential for development:
  - deepening comparative advantage, minimizing the gap behind world leaders in productivity,
  - high potential for export demand growth,
  - high demonstration effects of investments relative to both domestic learning and prestige building internationally.
- 7) Linkage capacity: backward to indigenous firms (e.g. the mobilization of domestic supply chain).

## **D. Integrated policy coordination, 2004–2006**

The 2004-2006 period of CzechInvest's "mission" brought new challenges to the country's transformation —the restructuring towards differentiated, high unit value products with a high content of

<sup>21</sup> Thus similar matching conditions had to be granted later to Hyundai —those, but no more. Hence both Czech acquisitions were settled in a cool and businesslike manner, and in conditions less costly to the national budget than Slovakia had to concede to KIA for its investment.

associated services. The continuous improvement in the competitiveness of the Czech economy would be promoted by widening the scope of coordination in policymaking. CzechInvest could not act autonomously without including SME development in its agenda. There was also the need to coordinate with projects financed by EU development funds and with support from the sectors of science, R&D and education. The latter implied a closer cooperation with the Ministry of Education.

The original task of promoting the acquisition of FDI was also modified: strategic long-term decision-making should take primacy over operational help to investors. The exclusive authority to submit applications for investment incentives to CzechInvest was extended to the power to deal with development funds from both the EU and the state budget; this made CzechInvest a unique agency in its field. The concentration of policies in its portfolio was thus much grater than how the matter was organized in Ireland, where similar agendas were spread over four (though closely interconnected) agencies: Forfas, the Industrial Development Agency (IDA), Enterprise Ireland and Science Foundation Ireland (SFI).

Indeed, CzechInvest's new strategy of cross-industrial policy coordination transcended all kinds of administrative support that was traditionally in the hands of various ministries without any coordinating agency.<sup>22</sup> The challenges of globalization, however, require that policies should be as flexible as are the external factors. The new organization of CzechInvest became an experiment, whose principles diverged from traditional Czech mechanisms of governance. Its project management techniques were more akin to the management of huge business corporations (such as Samsung, for example), with diversified activities crossing national borders. CzechInvest became an experimental pilot scheme of public governance for the twenty-first century. That uniqueness could not come out of thin air, nor could it come for free: it became a risky test of local high politics. The evolution of CzechInvest's staff and budget (for its internal administration and information services alone, separate from incentives provided by the Ministry of Finance) can be seen from Table 2.

**TABLE 2**  
**INTERNAL BUDGET OF CZECHINVEST**  
( in millions of Czech koruna and Staff)

	1993	1995	1997	1999	2000	2002	2004	2007
Total staff	14	24	32	35	44	54	320	140 <sup>a</sup>
State funds overheads	5,2	14,9	28,2	52,2	83,8	166,1	260 <sup>a</sup>	n/a
EU funds overheads	2,1	22,3	22,9	21,5	50,9	0	0	n/a
Incentives granted	0	0	1.3	3,1	14,9	17,4	16	47 <sup>b</sup>

Source: Supplier Development Database, 2007.

<sup>a</sup> Estimates

<sup>b</sup> In 2006

## 1. The merger of agencies: an alliance for cooperation

As mentioned, at the beginning of 2004 CzechInvest significantly widened and deepened its scope for action. As a result of the decision by the Ministry of Industry and Trade, CzechInvest integrated with the Agency for Industrial Development (CzechIndustry) and the Agency for Business Development. The new entity was called CzechInvest – Investment and Business Development Agency. The reason for

<sup>22</sup> The problem of national policy coordination must be solved at the government level. However, as the members of the government are generally politicians who come and go, coordination is not permanent. Thus governments often solve this defect by a professional and overarching "central coordinating body". For example, a model institution of this type has long been established in Britain. It is the Prime Minister's Delivery Unit, which works closely with ministries, monitors the reforms of public services and coordinates their policies.

merging these three different agencies was simple: the ministry strongly needed to find some government organization capable of dealing with intermediation for European funds, and of implementing them in a coordinated way.<sup>23</sup> With the staff enlarged to 320 and wide outsourcing capacities, it became a powerful instrument of both operational and strategic planning. Its executive and analytical capacities placed CzechInvest at the top of the public administration.

The choice of CzechInvest's involvement was on the one hand rational. There was no government organization in the country that had more experience of such coordination. From a pragmatic social viewpoint, however, it was quite a hazardous choice. In other words, there was no consensus on the sustainability of this merger from both CzechInvest's internal and external points of view. Re-training people from one successful specialization to another, and combining people from different managerial environments is risky. It opens the door to internal conflicts. CzechInvest's staff had to mature rapidly because there was a strong need for new capacities to cope with new and complicated seven-years program of European funds. CzechInvest was not originally projected to manage such an extensive bureaucratic agenda, and its human capital was in helping with private entrepreneurial tasks.

On the other hand, it is no novelty to go against tradition by creating an institution to coordinate specific ministerial agendas and control their implementation.<sup>24</sup> The main problem is the viability of political consensus across all parties and a disciplining deterrent in the hands of the Prime Minister. A change in government (not to mention a swing in Parliament after elections) should not pose a challenge to a revision of such a strategy. After all, one thing remains obvious: the transformation of CzechInvest into a development agency brought a significant number of new tasks, responsibilities and risks.

The first natural step immediately after this merger was to devise strategies to stimulate and strengthen the absorption capacity of local companies in the field of technologies that required skills improvement and identification of new opportunities in global markets. This agenda emanates logically from the previous stages of development in the country: the transitions from labor to capital and technology-intensive production, and from national to foreign drivers of development. At this stage the circle should be closed and modern technologies should also involve local enterprises.

The development programs that draw massively on EU funds should therefore aim at SMEs to a large extent. There were three departments managing the important steps concerning their implementation. The first was the Direct Support Department that monitored the Business Development Agency, together with CzechIndustry's traditional agendas, and dealt with grants and reimbursable aid. The Financial Schemes Department analyzed additional support for SMEs and mediated reimbursable aid and loans for them. The management of CzechInvest was aware that financial aid alone could be treated as a supportive injection but would not be sufficient if local co-financing (public and private) did not lead the path of change. The Consulting Department offered important knowledge and skills to raising the number of entrepreneurs interested in acquiring the services of qualified and professionally certified external consultants. The "Financial Guide for Small and Medium-Sized Enterprises" and the guidelines entitled "Which Way to the Money" were some of many instructions released for potential customers.

This support was helpful in furthering the enforcement of the knowledge economy, but at the same time it reveals limits that cannot be overcome by central coordination of the public administration. The set of strategic games undertaken had thousands of players who had to be ready to settle thousands

<sup>23</sup> The system of management of European Funds for 2007–13 is guided by the National Implementation Plan, which is split into programs. A country can choose any number of them and establish its own form of coordination. Most small EU members opted for a small number of programs (1–4). The Czechs, however, opted for 24, usually divided by the agendas of ministries and regions. The problem of coordinating the spending of € 43 billion on hundreds of projects coordinated by 24 programs in hands of 24 competing politicians is indeed a management challenge. CzechInvest became the coordinator on one such program: "Enterprise and Innovation."

<sup>24</sup> See our comment on the British Delivery Unit. Scrutinizing it from the point of view of management theory, such an organization in the type of a taskforce is not unique. It is a standard in the army where there is the unit of the Chief of Staff in parallel with the hierarchies of Supreme Command. Similar taskforce units are established within the management of multinational corporations.

of exchanges among themselves, with CzechInvest was in the middle. There had to be instruments to settle arising disputes. These instruments require collective action throughout society—that is, the co-acting of businesses, public administrators and social initiatives at the civil society level. The problem of social interaction is that such prerequisites of social consensus are seldom at hand immediately. It takes some time for all to adjust to the mechanisms.

## **2. FDI support**

The design of programs and policies was the competence of the Deputy for Strategic Development. She had to consult and coordinate decisions with the politically higher institution of government, the Ministry of Industry and Trade and the Deputy Prime Minister for the Economy, to whom CzechInvest was accountable. Later, the Department of Strategic Planning and Development was created for this purpose. In contrast to the 1990s, when the strategy focused on attracting FDI (based on low labor costs and an attractive geographic position in Europe, plus the investment incentives), in the new decade the stance was more pro-active as regards endowments for growth—that is, anticipating and promoting the long-term determinants of growth. Thus CzechInvest focused on factors that enhance the motives for production, and on services characterized by modern technologies, R&D, and high wages reflecting high productivity.

At the same time there was the need to support local startups in the SME sector. Sooner or later, strategic dependence on foreign capital will have to shift towards local catching up. The SME programs were financed (like many other restructuring programs) from the European Phare funds and were promoted in cooperation with the Ministry of Industry and Trade. In this case, technical assistance was provided by German consultants.

An independent market analysis of risks and obstacles to investment showed that the imperfect functioning of the real estate market was the critical barrier to rapid progress on investments. Bargaining with owners of land and buildings, who took advantage of investors/time constraints, was an obstacle of concern that discouraged foreign investors, who considered it a cultural shock. Hence the Industrial Property Development Strategy was launched to remove this barrier.

The Strategy for Brownfield Regeneration was another scheme that concentrated on the economic and environmental recovery of such sites. The quality of the environment, seriously damaged by communist neglect of this aspect of the economy, was a significant factor in the project analysis of foreign investors. They knew that future EU regulation could make them liable for such damages. They were also sensitive to their reputations as environmentally-friendly producers. The costs of investigating and cleaning up pollution were so uncertain that investors preferred a more expensive greenfield site. Brownfields might thus remain abandoned, which was socially too costly.

EU standards were therefore incorporated into the Investment Incentives Act that was embodied in Czech law, even though they reduced the level of state aid permitted for small companies under the previous arrangements. Furthermore, CzechInvest merged the General Support for Technology Centers with the Business Support for Service Centers, which eased coordination with the tertiary sector. Investments in regions with an unemployment rate above 14 percent received a high priority because they accelerated restructuring after the new laws on contract enforcement, bankruptcy and the privatization of banks in 1997–2004 raised the unemployment rate in some regions to more than 20 percent. Investors received financial aid to create new jobs, as well as for training and re-skilling employees. All investors promising to create at least 10 new jobs and investing at least US\$ 400,000 were eligible to take part in special programs.

To better address the problems of investors in regions of special interest, 13 regional CzechInvest offices were established. These were ready for on-the-spot consulting with both foreign and local stakeholders. Their customers mainly came with questions about the programs Industry and Enterprise, Human Development, and the Joint Regional Program.

### 3. The OPIE and the EU funds

The creation of a Division for the Coordination of Development Programs brought CzechInvest on track to be a development agency whose responsibilities transcended the traditional ministerial organization. It helped coordinate the industrial development programs implemented by private investors and co-financed by national and EU programs. It became a standard routine that CzechInvest acted as a mediator between MIT, the Ministry of Education, the Ministry for Regional Development, the Czech Energy Agency, CzechTrade, the Czech-Moravian Guarantee and Development Bank and some other ministries.

The Division for the Coordination of Development Programs prepared the implementation of the Operational Program Industry and Enterprise (OPIE). OPIE was one of the first programs launched under the umbrella of the European Structural Funds. Its rules and procedures had to be designed and made public long before the bidding process for EU funds started. The negotiations on establishing competitive administrative structures for the EU funds was one of the most complicated tasks CzechInvest had to undertake. The intertwined international and domestic levels of support, as well as the large number of applicants from home and abroad, placed additional demands on human resources—an agenda that would otherwise require a taskforce of several ministries.

In order to set up a transparent and viable national system for the Structural Funds, which evolved into a behemoth of bureaucracy, CzechInvest had to outsource many administrative and consultancy tasks. They could not be managed without the managerial techniques of large private corporations. The OPIE project was monitored via the ISOP Information System, designed for a direct link with Structural Funds Monitoring System. So the administration of applicants, the progress of investors and the control of payments ran on an online automated system. The system was co-financed by 25 percent from national public budgets and its total for 2004–2006 was €348 million (see Table 3). Additional private resources are not included in these statistics.

**TABLE 3**  
**FUNDING ALLOCATED TO THE OPIE FOR THE 2004-2006 PROGRAMMING PERIOD**  
(In millions of Euros)

OPIE priority	EU (ERDF) 75%	National budget (MIT) 25%	Total
1. Business Environment Development	130 426 070	43 475 356	173 901 426
2. Development of Enterprise Competitiveness	119 991 986	39 997 328	159 989 314
3. Technical assistance	10 434 086	3 478 028	13 912 114
Total	2 260 852 142	86 950 712	347 802 854

Source: MIT, annual implementation report for 2005.

To simplify the support procedures from the Joint Regional Operational Program (JROP), the Division for the Coordination of Development Programs agreed with the Ministry for Regional Development on the establishment of CzechInvest regional offices solely for the purposes of this program. These agencies were thus in close contact with investors and municipalities. They could receive better information about the obstacles to development and evaluate the financial health and credibility of projects on the spot. Having an intermediary between investors and municipalities that applied coordinated criteria to foreign entrants was a factor that stabilized their position because municipalities were not able to comply with them.

#### 4. Investors in People (IIP) and company competitiveness

A special part of CzechInvest policies consisted of programs aimed at the competitiveness of businesses. IIP is an internationally recognized human resource management program that connects different aspects of policies with a simple purpose: to raise the level of human resource (HR) management in organizations and improve efficiency. CzechInvest started to implement this standard to revise the competitiveness development and policies of qualification upgrading on the labor market. Within the EU Phare framework, a pilot program entitled “HR Development Standard – Investing in People” was launched in 2004. Applicants with the certified performance in HR management throughout the whole program received an accreditation, which empowered them to act as auditors.

The Profession Program was launched in 2005 as a follow-up to an earlier IIP. It was under the administration of CzechInvest’s biggest department, the Company Competitiveness Division (CCD). It targeted special educational programs for business employees and was financed by the European Social Fund. CzechInvest set the principles of the agency’s policies for upgrading skills and knowledge as “an investment in the acquisition of knowledge and skills that boosts one’s own capacities. It is a private investment that can be commercialized.” Hence it was expected that its beneficiaries should participate in its costs, at least symbolically.

It also became apparent that from the early stages of investment inflows, foreign investors had underestimated the educational level and skills of Czech labor. Their demand for skilled workers was thus low, and their employees had to take menial jobs that did not motivate them to improve their qualifications. Nonetheless, it is of interest to all parties —workers, employers and society— to build competitive endowments of human capital and to use them most efficiently. New investments should be therefore targeted according to the following priorities:

- To attract foreign investors who will open demand for jobs requiring a high level of knowledge,<sup>25</sup>
- to support the schemes for institutions that create and spread the knowledge and skills required by modern technologies. The supply side should advance over the widening demand side. Cooperation with the Ministry of Education, the Academy of Sciences and technological parks was part of the program.

The CCD was also responsible for the Consultancy Program. It was mainly devoted to the employees of SMEs that were ready to improve their business strategies or to people establishing their own businesses. A network of new consultants was required. In cooperation with the Regional Consultancy and Information Centers (RCIC) and the Business Information Centers (BIC), a series of outsourced outreach programs was prepared to accelerate the training of consultants. The programs were offered at incentive fees. The CCD’s Domestic Marketing Department (DMD) basically managed information distribution and communication with potential customers. It established a toll-free information telephone line and ran an updated website as a coordination tool. It also organized seminars such as Financial Forums for SMEs or International Cluster Conferences. In order to motivate new applicants, the DMD published brochures such as “How to Write a Business Plan”, a quarterly magazine called “Industry and Enterprise” and a periodical entitled “EU Funds for You.” Support from and cooperation with NGOs (that is, with parallel private initiatives) entailed leveraged efficiency.

The problem of many local businesses was their lack of know-how in modern technologies that had to be imported or licensed. Unfortunately, the strategy pursued by foreign firms was to attract the best-skilled workers by offering them wages that were 15 to 40 percent higher than what local firms could provide. The latter then had to bear three burdens in their efforts to catch up: their own lack of experience,

<sup>25</sup> Foreign investors initially (during 90’s) demanded mainly simple labor for their assembly lines. The demand for skilled labor kept accelerating. At present the enterprises complain about the shortage of qualified labor and the need to import workers from Poland, Slovakia, Ukraine or Moldova. The initial problem is reversed now: the FDI incentives are tempted to support the employment of unskilled laborers for who the demand got on a downslide.



the excessively high costs of having a skilled staff, and footloose experts. They would make only very slow progress if the government could not help them by means of a human resource support program.

The Competitiveness Development Program was launched by CCD to improve human resources and upgrade the skills of managers and entrepreneurs. It had three parts:

- The Competitiveness Program, calibrated to help companies in their further development, benchmarking and self-analysis through a 50 percent contribution to commercial consultancy fees.
- The National Registry of Consultants Program to facilitate the selection of consultancy partners. The aim was to upgrade quality and facilitate access to the services of private consultants. Since many of them had no business history, their services were non-transparent and risky. The certified consultant registry was organized by industrial domains, regions and specializations.
- The Czech Benchmarking Index was another tool to show the competitive status of a company in comparison to others in the market. This index gave enterprises a means of strengthening the competitiveness of their processes by catching up with leaders. This scheme gave institutionalized support to learning by doing and imitation, one of the most efficient ways of gaining competitiveness.

## **5. Summary of the CzechInvest management style in 2000-2006**

- CzechInvest had to behave like a private consultancy without being paid for its services by clients.
- The inspiration came from MNC management standards, not the standards of the government bureaucracies where steps on the hierarchy and age dictate the level of subordination and its constraints on personal initiative.
- Independence from the MIT in strategic decision-making was only informal. Although the MIT had instruments to veto CzechInvest's own decisions or even to enforce its own objectives, in reality the MIT-CzechInvest alliance was consensus-seeking and CzechInvest was able to uphold its views.
- Independence in the operational aspects of policy implementation was very high and delegated to divisions and teams.
- The recruited staff were very young, the average age being 28.6 years. Studies abroad were considered an advantage and study visits were encouraged.
- Employee salaries were subject to standard norms for the government sector. The average pre-tax salary of the junior executives was less than triple the Czech average wage (which was equivalent to US\$ 850 in 2006) —that is, about US\$ 1,960. The remuneration therefore could not compete with the salaries offered by multinationals in Prague.
- Employment in CzechInvest was considered of high prestige and headhunters considered it a guarantee of executive competence.
- The importance of ethics and behavior free of corruption were assigned paramount importance.
- Neutrality in politics and non-alignment with any kind of lobbyism.
- Explicit rules and codes of conduct strictly eliminating corruption were the guiding principles of professional performance.
- Personal contact with investors, mobility to the investment regions and fieldwork were part of working routines.
- Each project had its bottom line and workers were accountable to the heads of divisions.

## 6. Czech experiences of restructuring policies facilitating the transition to a more dynamic economic environment

- Gains from access to FDI and to foreign managerial skills are greatest just when the domestic economy gets through the first shock of opening-up, about 5 to 7 years from the start of transition. When the catching-up is more advanced (for example, after 15 to 18 years of transition) local entrepreneurs, managers and capital can gradually take over the role of leaders of growth and innovation. Thus government policies should continuously adjust to a changing situation, which CzechInvest did.
- The crucial conflict in managing industrial policies is that they should be embedded within private agents as cooperating actors, but the diminishing of distance between bureaucrats and business people opens up policies to corruption. Strict precautions must be taken on the part of the public administration to avoid the negative impacts of such a “partnership” of crony capitalism on the economic environment.
- The investment and development promotion agency must work in a competitive environment. Although its privileges are institutionally embedded, there should be open windows of opportunity to private investment/development agencies. Thus, in the Czech case, Inženýrsko-Investiční, Ltd. could compete with CzechInvest by offering identical services so that the flexibility of public services could be checked by potential private alternatives.
- Governments can be efficient in policymaking only if they have instruments and motives allowing them to distinguish “good” policies from “bad” ones. Hence bureaucrats must be able to break the barriers of information asymmetry and withstand pressure from the political opposition when some policies fail. The costs and benefits of doing “something” should be always be compared with the opportunity cost of submitting to any industrial policymaking.
- Policymaking is an evolutionary process wherein the government (or its agent) should behave like an entrepreneur: it must take risks, analyze their outcomes and re-adjust its means of implementation. There should also be one rather unusual proviso: a successful bureaucrat should be proportionally rewarded, while a failing bureaucrat should bear the costs. The Singapore country study by the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) stresses this condition. Here the parallel between business and government service is not symmetrical: while the principal loses his property, the bureaucrat (agent) can be only fired. Thus his or her rewards should be only partial.

## E. CzechInvest’s long-term strategies. Projection for 2007–2013

The CzechInvest Strategy Projection (CSP) was based mainly on the Czech Republic’s 2005 Economic Growth Strategy (EGS), which again was built on the more general guidelines set forth in the Sustainable Development Strategy that combined social, economic and environmental goals. Both of these were commissioned by the Czech government and prepared under the auspices of the Council for Research and Development headed by the Prime Minister. All three hierarchically combined strategies were the first official Czech documents concerned with this kind of planning, which were inspired by the recommendations of the Organization for Economic Cooperation and Development (OECD) and the EU’s Lisbon strategy. The EGS had three main objectives:

- To set the economic priorities for development in 2007–2013 that serve as directives for the coordination of long-term national policies with assistance from EU funds.
- To create optimal conditions for the autonomous economic activities of the clients of the state sector: citizens, entrepreneurs and corporations. Thus these three are defined as principals while the state is considered their agent.

- To establish institutions that guide economic agents towards efficiency. This concerns in particular the efficiency of public methods in areas of direct intervention.

The CzechInvest strategy for 2007–2013 is based on two SWOT analyses devised to distinguish desirable ends and means from their constraints, as well as poor approaches and the parameters of CzechInvest policies and the entrepreneurial environment in the Czech Republic.<sup>26</sup> The CzechInvest strategy is therefore not detached from the EGS but concentrates on balancing aims with existing means, and on ways of meeting goals on the operational side. CzechInvest could therefore deploy its policies on a more narrow field—that of exports, competitiveness and innovation (see Box 2).

## BOX 2

### LINKS BETWEEN ECONOMIC GROWTH STRATEGY AND CZECHINVEST STRATEGY PROJECTION

Areas directly or indirectly affecting the competitiveness of national businesses relative to competition from abroad were classified by five areas:

- Institutional environment affecting business performance.
- Sources of financing.
- Infrastructure.
- Human resource development—training and employment.
- Research, development and innovation.

Source: Author.

As mentioned, not all of the priorities outlined in EGS coincided directly with CzechInvest's lesser objectives. The structure in the graph below (see Figure 5) shows the ranking of priorities as envisaged by EGS. We will see that although the subset of topics dealt with in the CzechInvest strategy is more narrow, it concerned the implementation of core parameters of international openness.

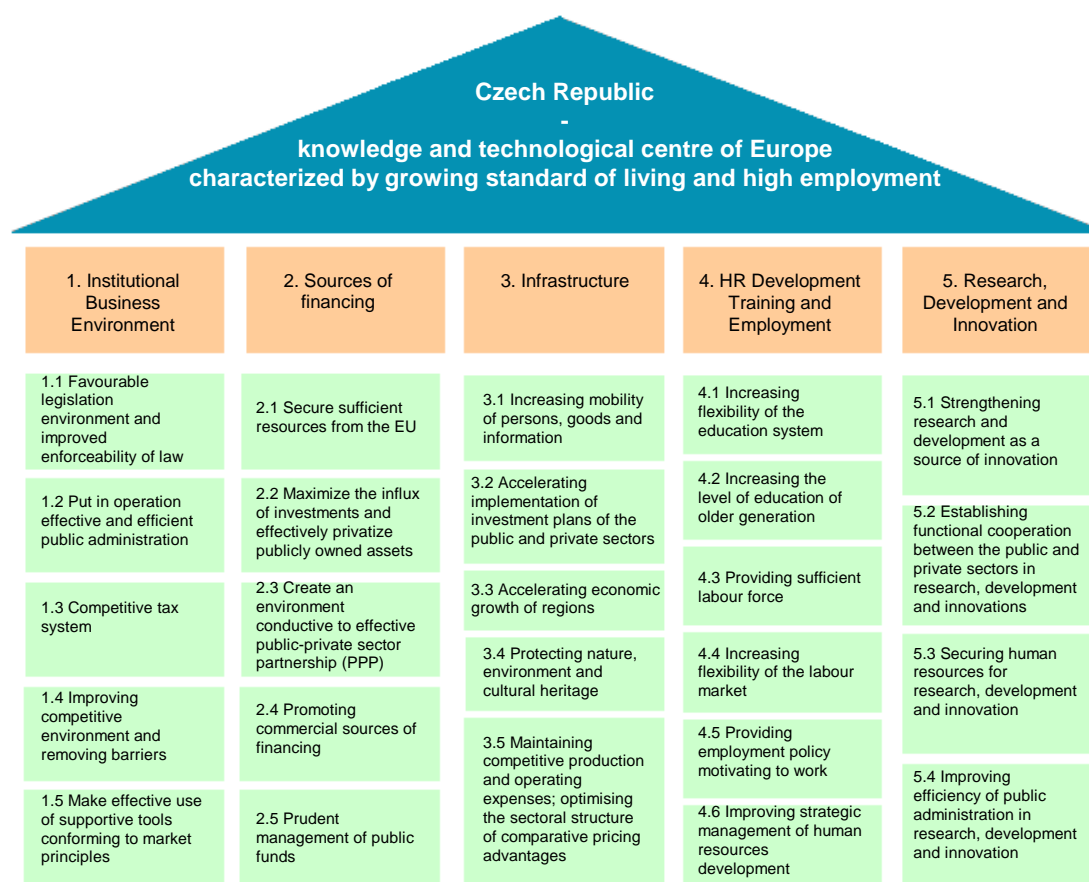
In the Institutional Business Area (first column) CzechInvest was essentially looking for Effective and Efficient Public Administration (field 1.2) in cooperation with the MIT and the Ministry of Finance. It dealt with the quality of public services, the efficiency of its clerks up to such details as electronic communication among and with the public sector. The policies of Competitive Environment Improvement (field 1.4) were targeted at the lower bureaucracy and other transaction costs of businesses. Support for entrepreneurship and SMEs was addressed in the Effectiveness of Use of Supportive Tools Conforming to Market Principles (field 1.5). CzechInvest aimed to use European funds to keep incoming FDI compatible with the development of national businesses.

Policies in the column of Financing and Infrastructure were not CzechInvest's direct priority, though they were a part of an interface with investment policies addressing the mobility of labor and the exchange of goods and services (fields 2.2 and 3.2). The most important shift from CzechInvest's past orientation, reflecting the shift from investment promotion to development promotion, was in the columns of Human Resources Development and R&D. In the former, CzechInvest was to provide greater support to education by linking it to businesses and the European Funds. The R&D agenda required an efficient linkage with foreign investment—either directly through inflows of ICT technologies or indirectly through their spillovers. For example, one of the highest priorities was high-

<sup>26</sup> In order to distinguish between EGS and CSP we should see that the EGS is a more general top-down projection: setting the priorities of growth while not presenting failures, threats and constraints in general. Therefore we should conceive the SWOT analyses as an opposite down-to-top audit with an objective to check how the outlined targets are consistent with the existing down-to-earth situation in the economy.

speed internet communication for businesses, public administration and schools. In this area CzechInvest became a crucial implementation agent of the EGS.<sup>27</sup>

**FIGURE 6**  
**RANKING OF PRIORITIES (OBJECTIVES AND THEIR MEANS) IN THE EGS DOCUMENT**



Source: Source: Economic Growth Strategy (11/2005)

CzechInvest's policies shifted quite suddenly into the areas of knowledge, know-how, skills, education, human resources and R&D. For example, it was to cooperate in raising human resource quality in businesses by advisory services and through a trio of supports: boosting skills level in companies by matching the supply of school leavers with companies' demand; mitigating unemployment in depressed areas by re-skilling and new investments; and removing the barriers to the growth of strategic business services and technology centers. CzechInvest was therefore to cooperate with the Ministry of Education in the raising of standards in universities, promotion of managerial education of students and portability of know-how and skills among sectors. The mobility of qualified foreign employees, studies abroad and managerial spillovers were another part of the strategy.

The support of competitiveness of firms and their potential for real growth (contrasted to "growth" based on price hikes or rent-seeking) is directly related to the potential of innovations. As marked by CzechInvest's official title "Agency for Investment and Business Development", policies directed at education, innovations and R&D must become the main instruments of its activities.

<sup>27</sup> Economic Growth Strategy of the Czech Republic, 2004, p. 74, chapter on Increasing Availability of Broadband Internet Connection.

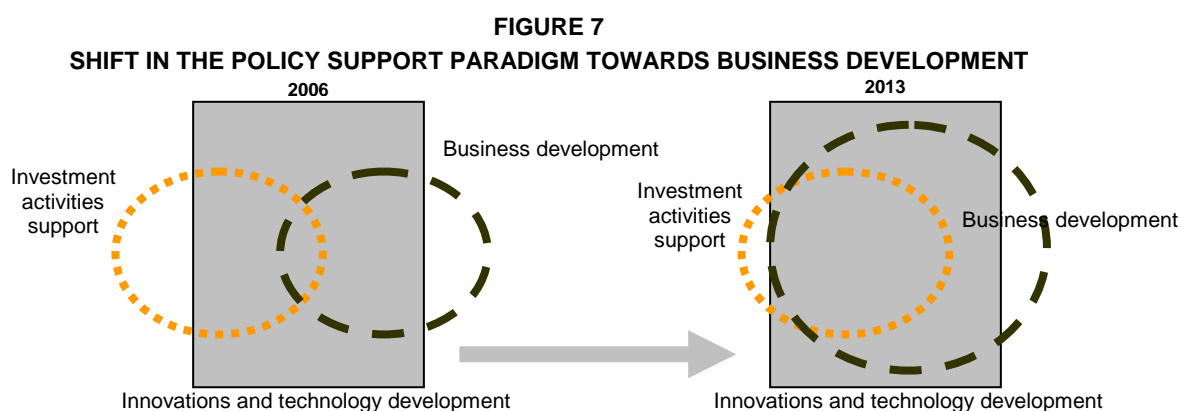
According to EGS, the progress in the Czech economy cannot do without primarily overarching the gap in the efficiency of R&D, which would then justify the secondary move in increasing its public co-financing.<sup>28</sup> EGS estimates that an annual increase in public expenditures on R&D by 20 percent to 25 percent until 2010, while a similar growth should come from the matching private resources. The public per private R&D funding should therefore remaining at the share 1:2.

The policies of CzechInvest could not then avoid interfering with measures for higher efficiency in the state administration (field 5.4). There should be implemented a new program targeting the feedback between public administration and the needs of private companies. To sum up, the development strategy of CzechInvest is to be involved in the following areas:

- Increase in R&D expenditures as a follow-up of raised R&D efficiency;
- intellectual property rights protection, which enhances its efficiency;
- coordination of financial sources dedicated to R&D from both the EU and the national funds;
- public dialogue among governments, enterprises and citizens about the ways for implementing innovations enhancing the growth and general welfare of citizens;
- greater cooperation between public and private sector because it is the latter that leads the path to sustained development.

As became evident from reaching the present stage of development,<sup>29</sup> notwithstanding the fact that the Czech Republic is a small country crucially dependent on international exchanges, its future depends on mastering the internal parameters of development: the endowments of national human resources, R&D and healthy institutional environment promoting entrepreneurial spirits, competition, social cohesion and efficiency. In another words, a necessary condition for a successful international cooperation is a strong local-market position. The gains from a highly competitive tradable sector cannot be wasted in the black hole of inefficiencies of non-tradable sectors such as public administration, healthcare, education or R&D. The success abroad starts at the success at home.

Figure 7 shows how CzechInvest envisaged its future orientation of policies. The core is the national development in innovations and technologies, which should be supported by investment and business development policies. The weight of the latter should increase substantially in time and integrate under its agendas the investment policies.



Source: Czechinvest strategy.

<sup>28</sup> EU's average R&D expenditure as a percentage of GDP is less than 2 percent. The EU Lisbon Agenda goal is to increase the amount of investments to at least 3 percent of GDP by 2010. Czech R&D expenditure of 1.6 percent is evidently insufficient for such a task.

<sup>29</sup> Czech present economic characteristics can be described as reaching the level of GDP per capital of Portugal, gradually catching-up with Spain and keeping up with the development in South Korea.



## Conclusions

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The expansion of services provided by CzechInvest since its inception in 1991 that in more recent years transcended the borders of ministries, the ability to change strategies for complying with evolving requirements and the success in attracting FDI in both the quantity and quality were widely conditioned by the fact that CzechInvest managed to avoid discords at the level of high politics. At the same time the departure of Czech political scene from a monopoly of one totalitarian party to a system of multi-party coalitions was not without problems of stability. For example, the three most powerful parties (i.e. the conservative ODS, Social Democrats SD and Communists) are not able to form coalitions and the government depends on the alliance with another two small footloose parties (Christian Democrats and Greens) that brings the balance of power at the knife edge.

So the politics of CzechInvest was to stay outside of politics – an attitude that worked until 2007. Nevertheless, its professional position was highly political: CzechInvest ruled over a crucial field of national industrial policies. With the access to foreign capital and the EU funds it became an agent of paramount political concern. Its main danger was in becoming a political instrument. The defense of their independence and professional competence was therefore in strict political neutrality and in an appeal for political consensus in its goals. This was accomplished thanks to the following:

Firstly, after the almost FDI-shy mid 90's two of the Czech strongest political parties (ODS of the right and SD of the left) agreed that the country needs FDI and that the FDI needs an institutional support across all politics. Secondly, from the beginning, CzechInvest showed

highly satisfying results, so no one with the competence of appointing a new CEO in order to reverse its strategies did so, even though political lobbies were often calling for a change. Thanks to the consensus in high politics CzechInvest could exercise universal innovative strategies and ensure for it the required level of independence. The fact that its CEOs were not replaced after every change of the minister of MIT (as it was a rule in neighboring countries), was a crucial moment for the development of the agency. It is worth mentioning that this relatively high level of independence, the stress on professional competence and the political neutrality of CzechInvest went along with the agency through the whole period of its existence up to 2007.

Aftermath of the most controversial polls of June 2006 that resulted in enormous problems in constituting a stable ruling coalition, led also to a split with the past politically neutral approach to industrial policies. With the reconstituted coalition of May 2007, the new Cabinet and the new libertarian minister of industry and trade, the politics towards CzechInvest called for a change. The CEO of CzechInvest (Mr. T. Hrudá) was called off and, in response of a protest, more than a half of the staff of 320 resigned from the agency. Since the early days of CzechInvest inception until 2006 the political power and the entrepreneurship of FDI promotion were subject to a consensus. The sudden clash between the economic logic of policy-making as a service and the political logic about public administration as a control over privileges, brought the past equilibrium between the public-private alliance to a watershed.

The future of both the agency and its industrial policies are now uncertain. The official argument of the Ministry was that CzechInvest broke several laws in the last year, that the efficiency of industrial policies were questionable and that there were alternatives to the style of running CzechInvest. The question is whether the loss of a centrally operated and entrepreneurially-driven institution of public administration could be substituted by piece-meal initiatives coming from the private sector. The paradox is that CzechInvest was not an impediment to private initiatives of investors above US\$ 10 million. It was just a service enhancing the power or markets in this segment of the economy.<sup>30</sup> Some marginal enterprises of the medium-size could be hurt with this system. That would be a serious flaw if SMEs would be direct substitutes to the large corporate sector. Facts do not support this hypothesis. Nevertheless, SMEs could have been compensated by government policies and institutional relieves operated by MIT, Ministry of Finance or European Funds. The performance of a sub-prime racing horses will hardly improve if one restricts the care allowed to be given to the champions. It is true, for many the care given to champions seems to be unfair. But it is then somehow forgotten that the public demand is for winning champions and not for the wannabes.

The particular reasons for the intervention are as important as are its consequences. The loss of the concentration of human resources in CzechInvest, whose unique expertise was built for long period, is definitely a loss. That loss occurred in an unfortunate moment: when the Czech Republic entered into the period of EU restructuring offensive with its 2007-13 cross-industrial programs of policies for competitiveness and cohesion, and when the Czech Republic should take over the EU presidency in 2009. The importance of policies coordinating the public and the private sectors, and the intermediation between national and international levels of decision-making have acquired an unprecedented importance. It is obvious that the importance of an agency akin to CzechInvest has not yet declined. The opposite seems to be true: this globalized world is particularly dependent on champions. We do not need performing champions among private businesses only, there should be the need for performing champions among public administrators, too. The criterion both is the outstanding performance, not the production of some medal.

If we would try to explain the roots of present uncomfortable situation and to learn from it for the future, we can come with the following hypotheses: The expansion of coordinated strategies of

<sup>30</sup> The logic of investment incentives is to support most probable winners because investment (in contrast to red bottom line or losing market share) is a proxy variable associated with expansion and successful business. Support of foreign investment implies a support of world-competitive business. Investment incentives are therefore a form of industrial policies that are most closely compatible with market forces. They are a sort of a leverage for supporting the winners already pre-picked by markets.



development into fields, which were traditionally the domains of certain ministries and political parties (i.e. the amalgamation of strategies of CzechInvest after 2003 driven by the entry of the economy into the club of advanced countries) is always a social experiment that is open to backfire. It has a chance for success only if there is a wide political consensus or/and if the country is on a verge of a shattering crisis.

The reality in 2007 was just the other way round: Czech politics were in a crisis and the economy was at its best. Every revolutionary idea of reorganizing the existing social order with the aim at gaining on economic efficiency is always socially and politically very risky. It opens the door to uncertainty and to the abuse of changes. The idea of integrating CzechInvest with the so far independent agencies of CzechIndustry, CzechTrade and SME Development, plus with some agendas of European Funds and policies of education and R&D, was a path-breaking social innovation. Therefore, even though it looked technically logical and backed by the evolution of economic environment, it became a painful political issue. Too many political structures would have to be modified and some of them would definitely lose on influence. Notwithstanding the outcome that the society would gain as a whole, some social groups would be open to the risks of reallocation and the ensuing costs of transition – so they would support the *status quo*.

As an alternative, there could have been implemented the standard second-best solution of a crawling evolution: that of incremental changes within the existing system. There was a counter-proposal of establishing an association, in which three agencies would keep their legal independence, but their cooperation would be much closer, so that they would not overlap and would not pass hot potatoes to each other.<sup>31</sup> This project was supposed to merge certain departments of the agencies, which could be run jointly by creating a small headquarter for coordinating the alliance. The three CEOs of the agencies would take turns in the leadership of the association, rotating every year. The project suddenly stalled when in the last phase of the conversion the CzechTrade withdrew their support and the Government opted for a more radical solution.

J. A. Havelka (the founding CEO of CzechInvest) agrees that the main problem, which escalated into the calling off T. Hrudá, was the absolute merger that occurred in 2004. With more responsibilities in the agenda of CzechInvest, more money were involved. The most enticing was the financial means coming to CzechInvest from the European Funds for the coordination of national “Enterprise and Innovation” project. That became a politically risky position for CzechInvest that kept a neutral relationship to politics. The major mistake was that amalgamated CzechInvest was not subordinated directly to the Prime Minister or at least to his first deputy.

An alternative to big plans are the small plans. Keeping CzechInvest at low profile as an investment servicing agency would imply little risks in external intervention. The antagonism between socially optimal first best and the second best of local stability is a case of prisoner’s dilemma. It is notoriously biased to socially suboptimal choices. So, CzechInvest and the Czech society received its dues. The only good in it is that the others can learn later from their flaws.

Throughout the existence of CzechInvest, the agency strived for acquiring the position that would not be exposed to political shake-ups. Its goal was to get autonomy from the MIT or, optimally, to get its position upgraded to an agency accountable to the deputy PM, becoming so a vehicle of inter-ministerial coordination. Such efforts increased in importance when the scope of CzechInvest policies had to target areas beyond manufacturing, industries and trade – such as the R&D and innovation, collaboration with universities and the harmonization of domestic policies with the EU objectives. Therefore the cooperation under the umbrella of MIT had no better option but to deal closely with the policies of the Ministry of Education, Ministry of Regional Development, Ministry of Transportation and the Academy of Sciences. Obviously, it was of little help to the power games of the MIT to let its strategic agency moved up in the hierarchy of influence. Thus stripping it off the power was more accommodating.

<sup>31</sup> Every country is challenged by this kind of strategic choice. For example, Ireland has not amalgamated its four institutions of economic promotion: Forfás, IDA, Enterprise Ireland and SFI. In addition, there remained three autonomous advisory councils: NCC, EGFSN and ACSTI. The problem is how to keep the decision-making both effective and politically stable by the degree of interlinking key stakeholders of industrial policies. The Irish solution seems to be more robust to shocks.

The shakeup of the 2007 illustrates how modern industrial policies are easily hurt by political weaknesses, even in cases of wavering that could be only temporary. It takes long time to build a functioning institution of restructuring policies that supervises both the strategies and the operational agenda. It is known from the experience of failing planned economies and of successful countries in the Far East that industrial (i.e. restructuring) policies can be neither designed nor executed by bureaucrats alone. Industrial policies have to be embedded within the operations of markets and, therefore, in an environment of coordination between the public and the private sectors. Otherwise the information and the coordination failures among businesses cannot be eliminated by isolated government intervention.<sup>32</sup>

It is not easy to come at this moment with an assessment of CzechInvest policies because there were many of them, acting often in mutual interdependence and they had its tides and ebbs changing over the time quite rapidly. At least, this confirms the presence of two important principles of industrial policies from the list of Rodrik, 2004, that we enlist below in the appendix 4.3: the existence of built-in sunset clauses and the capacity to renew (reinvent) its own activities. Indeed, CzechInvest reacted very flexibly to the rapidly evolving landscape of the Czech economy without defecting to *ad hoc* policies. CzechInvest has shown a clear drive to move away from the traditional Czech informal policy-making and the reliance on the network of clients –most probably the weakest links in the Czech social governance. In that respect it became the leading Czech institution of public administration. In addition, it was one of its rare institutions that had to fight for its position in an open international competition.

The rapidly changing landscape of CzechInvest's policies does not offer much information for the analysis of its individual cases. Analytical data should have continuity and permanence. In evaluating the performance of CzechInvest we can start by stating that the agency attracted US\$13412 million of FDI during 1993–2005. At the same time the Czech Republic attracted US\$ 47859 million in the same period, which means that more than a quarter of FDI inflows to the country were dealt with by CzechInvest. Private businesses had therefore sufficient space for acting on their own if the services provided would not be satisfactory. CzechInvest's bureaucracy and compliance costs were actually very low, thanks to its transparent rules. At the same time we know that incentive policies of CzechInvest were designed in a way that allowed for spillovers of positive externalities to all investors, even to those who did not take part in official schemes. CzechInvest thus acted as an instrument of leverage of policies throughout the economy.

Table 3 compares the FDI in the Czech Republic with other successful transforming countries in Central Europe. The progress in each of them would be very different if the countries would not have liberal investment policies and if their promotion agencies would not be present.

**TABLE 4**  
**FDI INFLOWS TO CENTRAL EUROPE, AMOUNT OF FDI INVESTED IN THE COUNTRY**  
(In millions of dollars)

	1990-2000 Annual average	2002	2003	2004	2005	Total	FDI capital in dollars
Czech Republic	2 131	8 483	2 101	4 974	10 991	47 859	4 679
Poland	3 699	4 131	4 589	12 873	7 724	66 307	1 721
Slovakia	422	4 094	756	1 261	1 908	12 239	2 248
Hungary	3 244	2 994	2 137	4 654	6 699	48 924	4 913

Source: ec.europa.eu/eurostat.

<sup>32</sup> The literature on this topic includes Evans P.: *Embedded Economy: States and Industrial Transformation*. Princeton, Princeton Univ. Press, 1995; Hausmann R., Rodrik D.: *Economic Development as Self-Discovery*, J. of Development Ecs, 72, 2003; Lall S.: *Reinventing Industrial Strategy: The Role of Government Policy in Building Industrial Competitiveness*, G-24, Discussion Paper no. 28, 2004; or Rodrik D.: *Coordination Failures and Government Policy: A Model with Applications to East Asia and Eastern Europe*. J. of International Ecs, 40, 1996: 1-22.

In 2005 Hungary and the Czech Republic reached the levels of FDI stocks that Portugal and Spain accumulated in 2002 since their openness to the world in late 70's.<sup>33</sup> As was already discussed above, the quantity of FDI is not the same as the quality of FDI. In the latter we should assess the whole process of attracting FDI and the spillovers FDI brought to the country. An objective economic evaluation of FDI attraction to the country as a whole is not easy. It is quite complicated to assess the social spillovers of FDI. It is even more complicated to quantify the opportunity costs of FDI –i.e. the potential development of the economy if domestic firms would not be challenged by foreign competitors and if many of them would not have to fight for survival. Last but not least, FDI is not coming to the economy for free. FDI is an investment akin to venture capital: it may help a lot to the national economy but its success is checked by the necessary profit sharing. Therefore dividends and interests from FDI and (rather less known) repatriated transfer prices, are the costs of having it in the country. The Czech FDI stock of US\$ 53 billion in 2006 generated US\$ 32 billion in aggregated official dividends, i.e. 61 percent. Fortunately more than a half were reinvested dividends, so that the net outflow represented mere 26 percent of the principal invested. However, the repatriated dividends have a sharply rising trend and the Czech Republic should be prepared for annual disbursements of US\$ 5 billion –i.e. more than all expected FDI annual inflows.

Until 2001 there were not many studies that would come with the conclusion that FDI into the economies of Central and Eastern Europe led to a significant degree of productivity spillovers into the domestic sector by means of technological transfers. Görg and Greenaway, 2002, quoted that none out of five studies of FDI in Europe prior to 2001 brought conclusive evidence about positive spillovers and actually four of them discovered the existence of negative spillovers at the enterprise level. Mencinger, 2003, was even more negative and suggests that the optimism about FDI externalities is a fiction because the negative trade-offs prevail. The first ones who came with positive news were studies by Campos and Kinoshita, 2002 and 2003, who discovered a positive robust link between FDI and industrial growth of the indigenous sector in eastern Europe. Surprisingly, the Czech Republic was a country showing the largest spillovers. Later Javorcik, 2004, found FDI productivity spillovers in their backward supply chains but little horizontal spillovers. More recently, a study by Ayyagari and Kosova, 2006, found a significant presence of horizontal and vertical spillovers of FDI in Czech industrial data for 1994-2000. Unfortunately it was the services only that were the clear beneficiaries of the FDI.

Notwithstanding the little evidence about spillovers (both positive and negative), there are prevailing conclusions in the studies of FDI in the CEECs that the advances in productivities occur inside of the incoming foreign enterprises. It is also the foreign firms that benefit most from the externalities of clusters. The business studies also reveal that domestic managers improved significantly by learning from the managerial techniques of foreign firms. There are therefore other and less disputed externalities that FDI brought with itself: those of the improvements in the local institutional environment and in the culture of entrepreneurship in general.

The final assessment of FDI promotion costs can be reduced to the following considerations:

- Is the trade balance posing a threat in its sustainability due to FDI related exports and imports?
- Is the balance of payments in disequilibrium because of the FDI related deficit in financial inflows and outflows?
- Is the economy with an intensive absorption of FDI having high or low rates of growth?
- Are the real wages rising?
- Is the foreign influence on domestic economy, social welfare and culture sustainable?
- Do the citizens feel well in a country intensively opened to the globalized world?

<sup>33</sup> That means US\$ 4360 for Portugal and US\$ 5290 for Spain in 2002 (statistics of UNCTAD, 2004).

The list of CzechInvest's achievements should not miss the following:

- The adoption of the Investment Incentives Act in a form of guidelines for a transparent strategic decision-making of all investors.
- Political neutrality that was upheld for 14 years, which was quite exceptional both in the Czech Republic and among the transition countries.
- Sticking to the principle that agencies of public administration must be in close contacts with the private sector and at the same time avoid being captured into cronyism and corruption.
- Effective management that was able to rely on techniques practiced by private corporate sector.
- Targeting its policies at the support of activities promoting competitiveness in technologies and not at attempts for picking the winning sectors.

As an attempt at evaluating the policies of CzechInvest according to criteria outlined by Rodrik /2004/ we cannot but accept that all of the Rodrik's principles could be found in the form or in the contents of CzechInvest policy design and implementation. Also the six examples of programs mentioned by Rodrik (p. 26-29) have their respective representatives in the Czech policies, even though not all of them were coordinated solely by CzechInvest.

The experience of former CEOs of CzechInvest (J. A. Havelka and T. Hrudá) and recommendations for other countries that consider establishing or developing an agency similar to CzechInvest can be summed up as follows.

- There is a crucial importance of the political consensus at the national level that must safeguard the agency throughout the whole time of its existence. Once the agency becomes a target of political fights, its efficient performance can no longer be upheld.
- Paramount ethical demands laid down upon the staff. The CEO of such an agency must be an experienced and widely respected person without any taints in his/her professional career and with high negotiating skills. Since persons with such qualities are extremely rare, it could be a foreign expert of acclaimed prestige and with experience in working in a similar agency. Then his/her leadership becomes a matter of national prestige that is not disputed.
- Human resources recruiting young employees. In case the managerial style diverges from the traditional routines of public service, the hiring of very young staff (the average age was 28.6 years), even to the managerial positions, is not a liability but an asset.
- Personal contact with investors and with field-work, complemented with personal accountability and safeguards against corruption.
- Targeting of the demonstration effects that act as a leverage. They cannot be limited on domestic externalities of efficiency only. There are also foreign externalities building the image of the country abroad. Like in any marketing, the prices of commodities rise when the demand finds them more appealing and when the trust in their long-term qualities prevails. Such externalities embrace all what the country does.
- Short-term gains must have lower priority than externalities and spillovers of long-term efficiency. Without them the FDI promotion misses its main mission.
- The style of entrepreneurial management. The management of national agencies of strategic decision-making should be commensurate to the fact that while development and restructuring institutions are a body of the public sector, their spirit and efficiency must be that of the private sector. Adopting the managerial techniques of the corporate sector are its salient feature. It is the transparency and the general access to incentives that distinguish the

performance-oriented policies from the redistributive rent-seeking policies. The risks of cronyism and corruption are present in all politics and policies.

- Development agencies should become national leaders in building the pockets of bureaucratic competence.

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### BOX 3

#### CONCLUSIONS CONCERNING THE RESTRUCTURING POLICIES CHanneled THROUGH INVESTMENT PROMOTION IN THE CZECH REPUBLIC

Czech policies of stabilization, restructuring and development were heterogeneous and they were flexibly adjusting to the changing reality in the world.

Approach by “trial & error” in designing the policy instruments could not be avoided. However, their usage was subject to political checks & balances, risk assessment and the screening of effects. The underperformance of some policy was a reason for its re-design or for closing down.

The main dangers of policies associated with incentives were: corruption, bureaucracy and political rivalry. The system of management was able to control them and minimize their occurrence.

The main drivers of progress in the FDI efficiency were seen in the promotion of entrepreneurship of incoming FDI (strongly supported policies) and the spillovers to indigenous SMEs (supported mainly by MIT, often in cooperation with CzechInvest, CzechIndustry and financial institutions).

The alliance on the side of public policies was formed by the cooperation between the following main bodies:

CzechInvest – in the leadership in policy-making (especially in investment strategies);

Ministry of Industry and Trade – in providing political support to CzechInvest and in its own programs supporting the SME, international trade (via CzechTrade) and innovation promotion;

Ministry of Finance – in providing the national funding (though lacking a strong strategic vision); Ministry of Education – in coordinating the national strategy of education, R&D development and a part of innovation policies (though being rather financially weak);

Ministry of Justice – in adjusting the procedures for property rights enforcement (though lagging by approximately 5 years behind requirements);

Ministry of Regional Development – in coordinating the EU structural funds with national regional policies.

Source: Author.

Improved economic policies, coordination between the institutions mentioned above and impacts of incoming FDI on the whole economy brought the economic growth above 6 percent for 2005-2007 and the prediction expects that high growth will be sustainable in longer period. Notwithstanding the success of policies, politics at both the central, regional and municipal levels are generally recognized as the weakest links in the national development. Some estimates claim that the impact of present weak politics on the growth is a decrease by 2 percent, relative to the growth potential. That implies at the same time that the natural growth generated by the private sector is robust enough to withstand ups and downs in local politics.

Compared to the catastrophic situation in the country in 1991, the Czech economy in 2007 has changed fundamentally and is able to compete on the world markets for constantly rising market share not only in its traditional domain (mechanical machinery) but also in many new brands of high technologies.



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## **Annex**

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## Annex 1 - Case studies

### 1. Skoda-Matsushita in Pilsen: on how to convert heavy machinery into electronics

Skoda Pilsen was one of the biggest centers of steel and machinery industries since the times of Austrian empire. It was famous for its long-range guns, turbines and locomotives. Since 1970's it was also a center of nuclear program. After the fall of communism this behemoth monopoly was nearly closed down. The problem of Skoda had two intertwined roots.

The privatization to an indigenous owner brought neither capital for the necessary technology and product modernization, nor the know-how needed for the market focus change from the east to the west. The company headed directly to bankruptcy. In 1999 an agreement was reached between Skoda and creditor banks and the situation was stabilized. In 2000 Skoda Holding (covering many subsidiaries) was set up and the ownership changed again when Appian Group in 2003 bought 100 percent of equity.

The product portfolio was extremely wide, practically without specialization throughout the supply chain. It consisted of many machinery products and also of own construction works, transport and catering. Many of these were free riding from the profitable branches (transport technology, energy and nuclear machinery). The company was focused by 80 percent on the domestic market, which was hardly developing. The new focus on core business and change of the orientation from domestic to world markets brought a positive change in the company economic results.

At the beginning of 1990 Skoda employed 40 000 workers. Now it is less than 4000 but the turnover and profits have been multiplied. Skoda became a problem of the whole region. In case of its complete bankruptcy the unemployment and poverty would be one of the highest in the country. It was evident since 1991 that the workers would have to re-trained and the industrial specialization would have to be re-oriented. This would not happen without the help of the government. The initiative started from the municipal government that converted the military airfield of 120 hectares into an industrial zone owned initially by the government. (Later the land was sold to investors and all costs returned with a profit.) The first idea was to attract the car industry, as the closest substitute for heavy machinery. Therefore the location of the industrial area was across the street from Skoda's estates. The industrial park thus could integrate with Skoda and reach also the campus of the local university. The spillovers from the park would be therefore multiplied.

The negotiations with Mercedes-Benz failed and the second choice fell on electronics, notwithstanding that at that time it was considered an industry without comparative advantages in this country. It was the correct choice – industrial policies should target industries that would break the barriers. Now electronics is acclaimed as a perspective booming industry in the region.

The Matsushita/Panasonic was in 1996 the principal investor in the whole region (and the first Japanese firm in the country) and it was also the first acquisition in the industrial area. This project was the first of this type in the Czech Republic where municipal government would be involved so intensively in such an extensive entrepreneurial venture. At the beginning, Panasonic employed 700 workers. At the present time it is more than 5000. In the entire industrial zone operate now almost 50 companies, which are employing 11 000 employees. The former assembly factory has changed into a production supported by high-tech services. The characteristics of the industrial area are indicated in Table 4.

The presence of Matsushita attracted an influx of investors into the area. The city reacted by establishing an R&D park. At present the area operates two large R&D development centers (a subsidiary of Matsushita/Panasonic and Mercedes), business incubator and service company with worldwide activity (Solectron). The cooperation with the local university, which specializes in electronics and machinery, is a part of the cluster. As the next step, Pilsen City has decided to build another R&D part (6th River) where the university will be a partner. The investment of Matsushita/Panasonic in Pilsen can be evaluated as a model of successful FDI in the Czech Republic.

**TABLE 1.1**  
**ECONOMIC CHARACTERISTICS OF THE PILSEN INDUSTRIAL AREA**

Newly created jobs	11000 (in 1998-2006)
Number of jobs in the walking neighbourhood (including Skoda and university)	16000
Investment by the municipal government	US\$22 million
Subsidies of the central government (via CzechInvest)	US\$3 million
Private co-financing	US\$1,3 million
Attracted foreign capital	US\$370 million
Attracted domestic capital	US\$110 million
Cost of one new job from public expenditure	US\$2200
Cost of incentives per private capital inflows	9,4%

Source: Author, based on official numbers

The Pilsen industrial area project is a result of successful interaction of regional and municipal governments, CzechInvest state agency with private businesses. Its establishment led to a creation of local cluster where the establishment of a large business (Matsushita/ Panasonic) led to spinoffs of R&D development and the establishment of indigenous and foreign startups, many of which were SMEs.

## **2. The Czech aircraft industry: the fall and the resurrection of aero industries**

If the communist high technology in the Czech Republic had ever achieved an international prestige in some technology it was in the aircraft industry. The top company among them was Aero – one of the world's largest suppliers of light military jets since 1960s. The rent-seeking of insiders brought it to bankruptcy and the ill-conceived industrial policies opened it to moral hazard. The sale to Boeing, as a strategic investor, shunted its state-of-the-art machines off the world markets. Finally, an indigenous Czecho-Slovak private equity investor, a start-up in the business, brought it back there with a clean bottom line.

AERO Vodochody, PLC, (hereinafter “Aero”), an aerospace producer established in 1919 was in the second half of the 20th century the world's biggest producer of military subsonic aircrafts. Its aircrafts of own construction supplied over 60 percent of the world's sales of training jets. Its light combat jets L-29 Delfin and L-39 Albatros were used all over the non-NATO countries during the last 46 years. The number of aircrafts produced exceeded 6500 units. The capacity in 1990 was over 100 units of high-tech jets. In addition, the Czech Republic produced top sport and acrobatic aircrafts and gliders and it had successful production of small passenger turbo-propelled aircrafts. From the technical point of view, there was hardly any reason why they should not be competitive abroad during transition. Nevertheless, all of them were nearly completely liquidated. Their case is a proof that in oligopolistic market structure institutional and political factors are more important than technological or economic proficiency.

From the very moment of transition in 1990 Aero lost its Eastern markets and it was obliged to change fundamentally its production activities. The over-staffing was at least treble of what an efficient producer would tolerate, there was a minimal outsourcing abroad and a low cooperation with strategic partners. The government fully controlled the management through its representatives in the board of directors and kept the company out of privatization. Soon it was clear that Aero can not survive without an intervention of the government. Instead of applying a strategic trade policy to bring the company in alignment with some consortium of fringe competitors on world markets, the company was kept in autarchy by subsidizing its production to inventories. The purchase of 72 new jets by the Ministry of

Defense for US\$ 1,6 billion, a sort of hidden subsidy in order to attract Boeing, did not solve the causes of problems, even though Boeing has finally arrived.

By presuming that on world markets it is the quality and high technology only that sells (as the doctrine of innovation policies claims) and, in defiance to policies of oligopolistic alignment, it continued in developing the L-159 state-of-the-art combat jet, where the possibility of international cooperation (e.g. with Brazil, etc.) was completely ignored. Similarly the extensive chain of Czech suppliers did not restructure in time, relying on the traditional industrial policy of “helping the future innovative winners”. The whole chain was on verge of collapse in 1997.

In 1998 the new cabinet decided to sell 34 percent of equity to Boeing. The trade was between the Czech and the US government without announcing any competition. The price was US\$ 16 million, plus offsets<sup>34</sup> of US\$ 42 million and a promise of an ambitious business plan to bring Aero again among the top of world players. The Boeing was given another incentive: the access to L-159 technologies in the category where Boeing was not so far ahead, plus the mentioned “fire sale” rescue contract from the Czech Ministry of Defense and a government guarantee for US\$ 400 million on the concluded commercial loan. Altogether the state aid reached US\$ 2,8 billion. The involvement of Boeing was a technological break-through. The new avionics systems for L-159 lifted the former low cost DIY-repairable aircraft into the category of top market where Aero had no previous experience and no customers. Hardly anyone from a developing country would dare purchasing such a jet that required wide technological support and an approval from Pentagon.

In an attempt to utilize its extensive production capacity, Aero decided to move into a new cooperation. There was a clash of interests with Boeing, which took new cooperation programs for a part of its own business and offset commitments. As a compromise, there was agreed the licensed production of Sikorsky S76C helicopter in 2000. The financial management of this new project was, however, lagging behind expectations.

For the duration of the partnership between Aero and Boeing none of the conditions, which had been enshrined in the jointly compiled plan for the period 1998–2008, were met. Boeing did not support the marketing of L-159 through its networks and no new contracts were established. There was a paradox: Aero could flood the world markets with the best jets in its category, able to match supersonics with its combat properties and electronics, but no government was encouraged to purchase them. Such sales are not possible without inter-governmental negotiations. Aero was again on a verge of bankruptcy. In 2004 Boeing sold its shares back to the Czech government for 8 cents. A partial change to the better came when the contract with Sikorsky was re-negotiated after Boeing’s departure. Subsidies for keeping the employees in had to continue, though.

In 2006 it was decided about privatization and, in defiance to the interests of some insiders, about a competitive bidding. The latter (where the EU competition policies stroke the difference) turned to be the crucial moment of the whole travesty of Aero. The only criterion became the price, not the “beauty contest” with promised business plans. Surprisingly, the clear winner was the local private equity group Penta with an offer of US\$ 116 million. Its new management designed a new immediate restructuring plan where Aero will discontinue on its dominant reliance on L-159, but will develop cooperation in components with firms delivering the final products (like Sikorsky or Airbus). As it happened so many times before in similar circumstances,<sup>35</sup> the government lacked the entrepreneurial “hunch” in

<sup>34</sup> Offsets are incentives of the sellers of armaments to the purchasing party (the government), which offer various intermediation services, such as reciprocity contracts and other aids in kind. The governments can then argue that the purchase of armaments (generally considered by public as useless) offers other advantages to the country. The problem of offsets is in the control of what concretely was actually agreed and how it counts. For example, all future sales from the purchasing country can be declared a part of the offset contract ex post. Also the litigation of the contract for offsets is usually difficult to enforce. In case of Boeing, offset “deals” that Czechs were not able to accept because they were not advantageous for the local enterprises (e.g. they require further local subsidies) were considered a fulfilled commitment by Boeing.

<sup>35</sup> The main Czech losses in the process of restructuring were Poldi (producing specialized steel alloys for high-tech industries), Tatra/LIAZ (producing 30 000 top heavy-duty military trucks a year) and Skoda Pilsen (energy

recognizing in which industries an indigenous firm can compete on globalized markets as a “super-tier producer” (i.e. a producer of its own final product), where it can be just an excellent outsourced supplier of tier-one and where the company should be rather closed down.

The potential of the firm revealed its power nearly instantly, once the strategy had clear objectives for survival. In six months the balance sheets of Aero turned for the first time to profits. The output increased by twenty percent even though the staff was cut by 400 employees. New contracts were signed, promising the volume of sales to double in the next three years. The demand for local outsourcing (based on the technological cluster spun-off from the automobile boom) and for high skilled employees will rise. Most probably these will not be the skills for replacing the super-technologies of Boeing, but the position indigenous producers in the second-tier high-tech will definitely strengthen. The plans are to recover also the production of sport and passenger aviation industry. For example, Czech Aircraft Works of Kunovice has been recovering from the past depression and it expects to sell 140 light sport aircraft in 2007. A similar recovery has occurred at Moravan Aviation producing acrobatic aircraft. Present total employment in aircraft and space industries of 7000 can thus recover to previous levels. Industrial policies in this specific segment of technologies and marketing have definitely its place; however, they should be also restructured and targeted at activities where they are efficient.

Conclusions for the government policies from this case study:

- The objectives of national self-reliance in the full supply chain of products are counter productive.
- State corporate governance (even tough at a level of “marginal control”) is dangerous –not so much for its entrepreneurial incompetence but for the incentives of moral hazard it opens.
- Selling to a foreign strategic partner of the first class (e.g. to Boeing) can backfire whenever there arises a conflict of interest within the hierarchy of the dominant firm. The risk of a hostile takeover is lower when the partner has less dominant power and more incentives for a strategy or cooperation.
- Privatization of an enterprise cushioned by an access to state support schemes tends to end up in an auction of future subsidies, not an action of future revaluation of assets (equity) owned.
- The contestability of the tender is a crucial criterion. It should have just one criterion: the price free of any future subsidies.
- Contracts accompanied by offset clauses become highly opaque and difficult to enforce them. They should be excluded a priori from any government negotiations.
- Search for the location of a firm within the network of international supply chains in an entrepreneurial art that cannot be done by the state. Its policies, however, can successfully target the mitigation of risks from restructuring. They can support the information flows, encourage the setting up of social infrastructure required for restructuring and build the trust among potential partners where overcoming of uncertainties needs credible external guarantees.

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production equipment). All of them could survive if the policies used would be more pro-competitive, pro-restructuring and tied at the end to an optimal position in the international supply chain. Skoda-Auto can be taken for a comparison. Its privatization to VW brought it to technological peaks and its present employment is 27000, plus the employments is associated spinoffs of 83000. The art of transition from a former vertical or horizontal monopoly to independent firms competing on world markets rests in finding the optimal size and location in the supply chains. This cannot be decided by the government. However, its policies can speed up and make the search of relocation more efficient. It is aging the problem of information and coordination failures the industrial policies can mitigate.

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