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„Determinants of Foreign Direct Investment and its Impact on the Slovakian economy “

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Preface

Foreign direct investment is a key component in the development of all countries in the world and therefore has a very important role in global business. The advantages for the investing firm can include cheaper production facilities, new markets and marketing channels, access to new skills, products, technology and financing. For the host country or the indigenous firm which receives the investment the benefits lie in the new technologies, processes, capital, products, organizational and management skills, and therefore can provide a strong impetus to economic development.
The Slovak Republic began to look for foreign investments because insufficient capital led to difficulties achieving the development goals, which were proposed by the government. Due to the strategic change of the economy as a whole, attracting foreign capital had and still has a high priority. Of course, as there are many advantages to foreign investment for the Slovak Republic, there are also disadvantages which cannot be ignored.

In the first part, this diploma thesis aims to provide an overview of the foreign investments, their determinants and functioning. The third and fourth parts investigate the impact and development of foreign direct investments in Slovakia.

Finally, I want to thank Dr. Besim Yurtoglu for his advice, comments and cooperation.

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INTRODUCTION

Foreign investments are one of the biggest issues in the current Slovakian economy. As an illustration of their importance, one could take the statements of expert analysts, press and organizations, which point out the advantages and disadvantages of the entrance of foreign investors in Slovakia. As the newspaper Pravda (2009) stated "…*foreign direct investments became the engine of the Slovakian economy in the last few years. Volumes grew in both car and electro-technical industries, which in turn increased the exports, industrial production and even the employment in the country. Later on, orders from abroad decreased and this had a negative impact on the balance of trade and payments and also caused the economic growth to decelerate*." The Slovakian Ministry of Finance (2008) stated that mainly "…*foreign direct investments are responsible for a dynamic economic growth and for positive balance of payments*."

The statement of the European commission (2000) that "*Investment flows benefit everyone, creating opportunities for investors and helping developing countries to achieve sustainable development; but FDI needs the stable, transparent, predictable and non-discriminatory business climate that multilateral rules provide*" applies also to the foreign investments in Slovakia and its importance does not have to be stressed explicitly. The main results of the foreign investment`s influence is more likely visible in the following macroeconomic indicators:

- Employment
- Liquidity
- Regional development
- Know-how
- Social sphere

The next component of the foreign investment activity is its multinational importance, where the transformation process in the Eastern and Central European countries should put the economy level closer to that of the Western European countries.

There are a number of reasons why I chose the issue of foreign investments in Slovakia. One of them is that foreign investments are often criticized by miscellaneous papers and literature (Kiely 1998, Morgan and Katsikeas 1997 et.al.).
Furthermore I would like to provide an image about the determinants, effects and the development of FDI on the economy of Slovakia. I also felt motivated by the Slovakian government's mission to support the economy by presenting a healthy economic environment of Slovakia to foreign investors. In any case, there are other ways of reducing unemployment, supporting export activities of Slovakian entrepreneurs and administering the EU structural funds.

The development of the world`s economy is currently influenced by integration and globalization processes, which create a different quality of international economic relationships and investment policy. This can be seen in every segment of the economy which dramatically influences the development of transformation processes in various countries including Slovakia.
Investments have an important role in the national economic level in every country. For optimal allocation of investments, as the most important factor in the economic development of Slovakia, is the knowledge of theory about investments especially about foreign direct investments even if the literature considers different types of FDI structuring, which are the main topic of this diploma thesis.

"Anything that makes your attempt to buy an asset more risky can have a material effect on the amount of investment we get. These days, we'd be lucky if we get lots of foreign direct investment. We should not restrict it. We should make it easier."

Nouriel Roubini (2006)

1. Theoretical aspects of foreign investments

One of the main efforts of each country in terms of economic policy is to support the restructuring and competitiveness of the country. The biggest hurdle to achieving a rapid economy growth might be a lack of capital resources. Therefore the inflow of foreign capital plays an important role in the country.

1.1 Forms of foreign investments

Foreign capital movements take place mostly in the form of:

1. Portfolio investment
2. Bank loans and long term credits
3. Direct foreign investments

The classification of foreign capital flows is not possible for all purposes. Foreign capital flows are subject to many factors e.g. *time* (long-term and short-term capital and also the temporary and permanent capital). Various influences are observable in periods of economic crises as well as in periods of relative economic stability. Other movements might occur in developed economies etc.

1.1.1 Portfolio investments

Hoskova (1999) finds that "*portfolio investment represents the transfer of ownership of securities and the main purpose is to achieve a certain return of the value. They are influenced by factors such as profit, interest rates, but also a variety of speculative manipulation. Under certain conditions the impact of these factors could change quickly in a positive or negative direction and thereby have a destabilizing effect on the country's well being. The scope of foreign investments entered into various types of securities depends on the development level of the capital market.*"

Portfolio investing does not aim to control the foreign capital, but rather involve risk diversification and optimal allocation of assets in terms of three criteria - performance, risk and liquidity. To put this simply, the foreign investor of long term capital does not control

or manage the firm abroad but he benefits from the capital invested in foreign country (interest, dividends, profit-sharing, etc.).

The benefits and risks associated with inflows of portfolio investment (Hoskova, 1999, p. 2-3).

Advantages:

- Increased share in the risk
- Transfer of technology and of know-how
- Access to the world market
- Stabilization or growth in employment
- Long-term increase in market oriented capital
- With a foreign competition, a downward pressure is exerted on domestic interest rate levels, mobilizing domestic capital for local companies at lower cost.

Risks:

- maturity of bonds may be insufficient to finance long term projects
- Concerns about the instability of short-term capital (short-term investments are withdrawn from country as soon as a negative step is taken against them. Large withdrawals may lead to serious problems within the country).

1.1.2 Foreign loans

Foreign loans are a less efficient form of foreign capital acquisition. The borrowed money has to be returned at the agreed time including interest. If these financial resources are not invested properly, then these resources will not deliver the expected benefits. To obtain foreign loans it is necessary to develop credible projects which will ensure a certain required rate of return for the lender (Hoskova, 1999, p. 2).

1.1.3 Foreign direct investments (FDI)

These investments are considered as the most effective form of foreign capital inflow. This form of investment allows investors to acquire stakes in capital of specific business organizations in the host country. Unlike portfolio investment, direct foreign investment

allows direct participation in the production, business or services sectors of the economy concerned (Hoskova, 1999, p. 2).

1.2 Definition of Foreign Direct Investment

Restructuring of enterprises in transition economies requires large investments in to morally or physically worn-out equipment and physical capital. One type of investment with these characteristics is also foreign direct investment, which can be defined by multiple views:

Slovak Republic´s Foreign Exchange Act (2002) defines foreign direct investment as "*the deployment of such funds or other financial assets or other property rights, whose purpose is the establishment, acquisition or expansion of economic relations of a resident investor or residents as individuals acting according to an agreement for investing abroad or foreigners or strangers as individuals acting according to an agreement for investing in inland ...”*

Under current legislation, FDI is an expenditure of such funds or other financial assets or property rights, whose purpose is the establishment, acquisition or expansion of economic relationships of residents investing in businesses abroad or foreigners investing in business in this country, and any of the following :

— The International Monetary Fund defines FDI (2003) as follows “*FDI is a category of international investment that reflects the objective of a resident in one economy (the direct investor) obtaining a lasting interest in an enterprise resident in another economy (the direct investment enterprise). The lasting interest implies the existence of a long-term relationship between the direct investor and the direct investment enterprise, and an investment relationship is established when the direct investor has acquired 10 percent or more of the ordinary shares or voting power of an enterprise abroad*.”

— According to the *UN definition*, these are investments which are based on long-term relationship and lasting interest of an entity established in one country (direct investor) for the entity established in another country.

— According to the *U.S. Department of Commerce* all foreign companies can be identified as foreign direct investment in which a U.S. citizen, company or group holds a share of 10% or more.

— Another expert definition by Lindert(1976), *"foreign direct investment is a flow of business capital in the form of a mixture of management skills and financial loans*"

From these definitions it is clear that direct foreign investment do not involve only the movement of funds, but also the transfer of management, experience, trade secrets, technologies, rights to use the label, know-how, marketing strategies and so on. They are associated with some degree of control, but it is not determined what proportion ensures the owner of the company the full control. There may be a situation where a 100% ownership does not guarantee absolute control if the company must follow certain host government restrictions. However, the majority of the literature indicates a 10% to 25% as a prerequisite for the classification for direct investment.

The main reason for the growth of foreign direct investment among developed countries was the rapid growth of scientific and technological development, which significantly reduced the role of low-cost (unskilled) labour and on the other hand, underlined the seriousness of the qualification environment with the ability of innovation flexibility, high levels of infrastructure and so on. Increasing innovation dependence is usually associated with ownership advantages. This fact is closely related to large sized international corporations which expand their international network as a part of a global or regional production or processing strategies. Such benefits can be characterized as synergetic, because the profit earned is a result of a combination of whole set of complementary activities. Foreign direct investments are also directed to countries where all this is not completed yet, but it is realistic to expect that economic development will be positive. The impact of foreign direct investment always depends on the type of investment and socio-economic conditions of host and home country.

— **The structure of foreign direct investment**

Based on the definitions and characteristics of FDI we can classify their structure according to:

— The ownership proportion and
— the functional point of view

Foreign direct investments can be distinguished with respect to *the ownership proportion*, which is an essential aspect for the structure of FDI investments, as a:

1. 100% ownership by foreign investors
2. joint-venture

Investments with 100% ownership by foreign investors are now the most common form of operations within branches of multinational corporations (MNC) or transnational corporations (TNCs). A single definition for such corporations still does not exist but many companies of this nature have similar features (such as managing and operating facilities in several countries etc.).

Studies such as Debaere (2003), Chang (1995) et. al about the expansion of corporations show that companies are becoming multinational gradually, with FDI as the last step in the process of expansion, which begins with export.

These corporations use direct investment if (Ferenčíková, Michník and Šesták, 1997, p.34):

— The parent company acquires a sufficient number of shares in foreign companies that ensure its control
— The parent company of acquires or establishes new companies and branches abroad
— the parent moves funds to finance the development (expansion) of its foreign branches, companies or transferring funds to the companies, in which it already has a decisive participation
— the income of businesses and foreign branches of the parent company are reinvested into further development

Furthermore, these corporations are characterized by economies of scale, specialization of production, flexible information flow and R&D co-financing.

Joint venture is a form of strategic relationship which utilizes separate business entity (corporation, company or partnership) and allows two or more parties to collaborate in a specified business activity which is determined by the contract, or which was established by the government of resident company (Gutterman, 2002, p. 1).

Other authors describe the joint venture as follows:

- *is a business organization established by two or more companies that combines their skills and assets (Garbaugh, 2009).*
- *An entity created by two or more firms to combine their own resources and capabilities (Harrigan, 1986).*
- *Is an enterprise formed for a specific business purpose by two or more investors sharing ownership and control (Onkvisit and Shaw, 2004).*

Three types of international joint ventures can be distinguished (Carbaugh, 2009, p. 316):

1. Companies from the two countries establish a joint venture in a third country
2. Companies from the two countries establish a joint venture in one of the countries to meet their own corporate interests
3. Companies from the two countries establish a joint venture with certain participation of local government, thus pursuing their own interests and the interests of the host country

Joint ventures can be also distinguished by following criteria (Ferenčíková and Michník, 1997, p.34):

- Internationality
- Limited duration
- Limited goal
- Partial function

Depending on the combination of criteria and goals chosen by partners we can also distinguish following joint ventures (Ferenčíková, Michník and Šesták, 1997, p.36):

- Horizontal – alliance between same partners
- Vertical - an alliance between the producer and subcontractor or between producer and distributor
- Diagonal - one of the partners takes the financer role or two producers combine their different technologies with a goal to achieve a new joint product

From a functional point of view we distinguish investments as (Carbaugh, 2009, p. 305):

1. Vertical Investments
2. Horizontal Investments
3. Conglomerate Investments

1. Vertical Investments occur when the parent and daughter companies are specialized in different production phases. This specialization depends on the sources of an individual country.

- Backward Integration may include the extraction and processing of raw materials. Most manufacturers (such as international oil companies) tend to extend operations backward only to the production of component parts.

- Forward integration occurs when the parent company establishes foreign subsidiaries to market finished goods plants abroad for its products. This progress is very common in the car industry.

Carbaugh (2009) states, that "*in practice, most vertical foreign investments is backward. Multinational corporations often wish to integrate their operations vertically to benefit from economies of scale and international specialization.*"

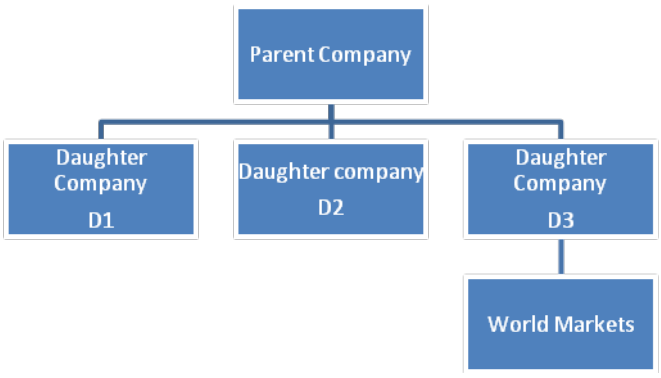


Figure 1 *Vertical integration between the parent and daughter companies*

2. Horizontal investments – parent company invests horizontally if the subsidiary branches perform the same functions as the parent company that is, for example they produce the same products.

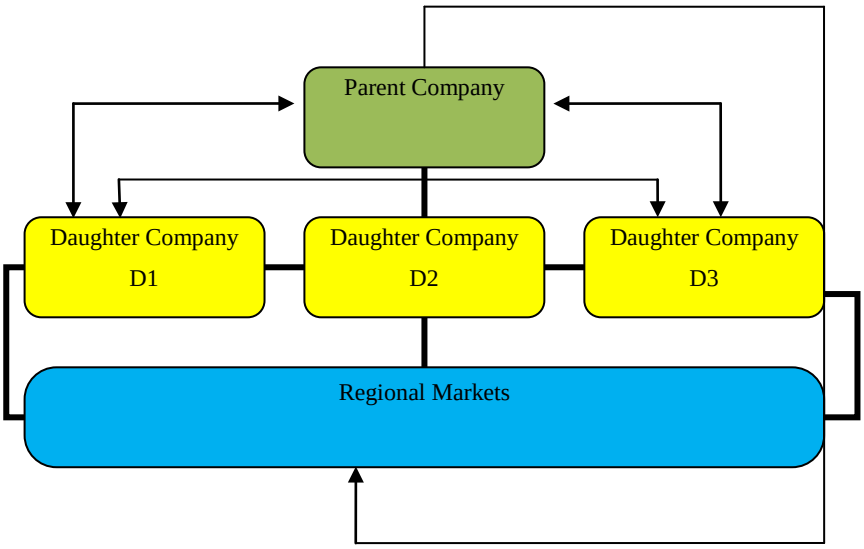


Figure 2 *Horizontal integration between the Parent and daughter companies*

3. Conglomerate investments are those which go into areas unrelated to the original principal activity of the parent company. For example, major oil companies in the 1980´s anticipated a decline in investment opportunities in oil and gas and therefore entered into other business areas e.g. Exxon Mobil acquired a foreign copper-mining subsidiary in Chile and Tenneco bought in Europe a French company producing automotive exhaust systems (Carbaugh, 2009, p. 304).

1.3 Theoretical approaches to foreign direct investment

Theories on foreign direct investment try to explain why multinational corporations indulge in FDI, why they prefer to invest in one country over another and why they choose a certain entry mode. These theories also explain why some countries are more successful in attracting foreign investors than others. The structure of theoretical approaches of foreign direct investment can be categorized as follows (Lizondo 1991, Agarwal 1980):

1. FDI theories assuming perfect markets

2. FDI theories assuming imperfect markets

3. FDI Theories considering risks, policies, trade barriers, regulations and strategic and long-term term Factors

4. Entry mode FDI theories

5. Other FDI Theories

Using the book of Imaad A. Moosa (2002) as a base, the subchapters 1.3 and 1.4 will provide an overview of the theoretical explanations of foreign direct investment.

1.3.1 FDI Theories assuming perfect markets

The differential rates of return hypothesis is one of the oldest FDI theory. This hypothesis assumes that capital flows from countries with low rates of return to countries with high rate of return move in a process that leads eventually to the equality of ex ante real rate of return. The rationale behind is that firms which consider FDI behave in such a way as to equate the marginal return and the marginal cost of capital. This hypothesis postulates risk neutrality, making the rate of return the only variable upon which the investment decision depend. Risk neutrality in this case implies that the investor considers domestic and foreign direct investments to be perfect substitutes. Many studies (Agarwal 1980, Weintraub 1967 et al.) aimed to test this hypothesis but failed to provide the supporting evidence. One

problem with the differential rates of return hypothesis is that it is not consistent with the observation that countries experience inflows and outflows of FDI simultaneously. The reason for this inconsistency is that the differential rate of return implies capital flows only in one direction e.g. from low-rate country to the high rate country but not vice versa. Another problem is that testing this hypothesis entails serious statistical measurement errors. The problem is that testing is based on the rate of return calculated from expected profits an actual profit. In practice it is rather difficult to obtain evidence on the divergence of reported profit from actual profit, but in general the available evidence (Bhagwati, 1967) indicates that reported profit fails to reflect accurately actual profit. Furthermore, multinational corporations may indulge in FDI for reasons other than profit, particularly in the short run and medium run. Their objectives for instance can include sales revenue maximization, market penetration, circumventing the trade barriers, maximization of rate of return per unit of risk etc. Furthermore, the hypothesis also does not explain why a firm indulges in FDI rather than portfolio investment (Moosa, 2002, p. 24).

Unlike the above mentioned hypothesis *the Portfolio Diversification hypothesis* assumes that the choice between various projects is guided not only by the expected rate of return but also by risk, so risk becomes another variable upon which the FDI decision is made. The idea of reducing risk via diversification that is relevant for portfolio investment is also considered here. Capital mobility in this hypothesis is constraint by the desire to minimize the risk, which is achieved by diversification (Tobin 1958 and Markowitz 1959). Agarwal (1980) and Hufbauer (1975) tested this hypothesis by examining the relationship between the share of FDI going to a group of countries and the decision variables (rate of return and risk measured as the standard deviation of the rate of return). The results provided only weak support for this hypothesis. Furthermore the hypothesis pertains a trade-off between ex ante return and risk (higher risk is accepted only for higher returns and vice versa). Another problem is that risk and return are calculated from reported profit that is unlikely to be equal to actual profit because of transfer pricing and accounting procedures. Finally, the risk cannot be measured accurately from historical data. However, the fact is, that diversification hypothesis is superior to the differential hypothesis for the following reasons (Moosa, 2002, p. 26):

— It considers risk as an additional variable, which is an important decision aspect for FDI
— It can be generalized (Prechowny, 1972)
— It offers a plausible explanation for cross-investment between countries and industries (Agarwal, 1980)

The drawbacks include the lack of explanation as to why multinational corporations are the greatest contributors of FDI and why they prefer FDI to portfolio investment.

According to Moosa (2002) the *market size hypothesis* implies that *the volume of FDI in a host country depends on the market size which is measured by the sales of a multinational corporation in that country, or by the country´s GDP*. Balassa (1966) finds that a sufficiently large market allows for the specialization of the factors of production and consequently the achievement of cost minimization (economies of scale). The relationship between direct investment and output can be derived from neoclassical models of domestic investment. Jorgenson´s model (1963) stated that firms increase their investment in response to their sales. Agarwal (1980) on the other hand doubts the significance of this relationship because:

— The relationship is based on the assumptions of the neoclassical theories of domestic investment that are most likely unrealistic
— Since this hypothesis is based on neoclassical domestic investment theories, investment should be defined as including expenditure on plant and equipment only, but statistics do not distinguish between expenditure on plant and equipment and other forms of investment.
— The decisions of a firm regarding initial FDI and expansionary FDI are likely to be guided by different considerations
— Market size is likely to influence the FDI undertaken to produce goods for consumption in the host country and not the FDI aimed at exports. Statistically it is hard to distinguish between various types of FDI.

Empirical studies (Moore 1993, Bajo-Rubio and Sosvilla-Rivero 1994, Wang and Swain 1995 et al.) used real GDP as a proxy measure of market size in the host country and found

it to be a significant determinant of FDI. More recent studies (Yang et al. 2000) did not find a significant relationship between FDI and GDP. Other proxies such as growth rate of GDP was considered as a measure of the future potential of the host country´s domestic market while GDP per capita represents the level of the host country´s economic development (Schneider and Frey 1985, Yang et al 2000). The study of Lipsey (2000) using the size and growth variables concludes that inward and outward FDI stocks and flows seem to go together across countries and over time. Finally a recent survey of Kearney (2000) which is based on the views of 135 executives of the world´s 1000 largest companies and who gave marks on a scale of 0-3 for the likelihood of investing in a particular country concluded that size of a market does matter as shown in the results. For instance the most favored countries for investment turned out to be USA, China and Brazil (Moosa, 2002, p. 26-28).

1.3.2 FDI theories assuming imperfect markets

The industrial organization hypothesis is based on the assumption that if a firm invests abroad, it is exposed to numerous risks and bears various additional costs compared to domestic firms. The disadvantages include, for example the exposure to the unknown market, legal system and cultural environment, which creates communication problems, rising costs due to distance from the parent company and also commercial and foreign exchange risks. Such additional costs may be offset by the company only if it has some specific advantages such as well known brand name, patent protected technology, managerial skills and other firm specific factors over the local firms. The theorists, who pointed out these aspects, are Hymer, (1960, 1976-published), Kindleberger (1969), Caves (1982) and Dunning(1988). In their view, the domestic company has an advantage over a foreign company and if this foreign firm wants to overcome the natural advantages of the domestic business environment it has to have some other quality already mentioned above. Other than that, in order to stay competitive the foreign company must not only generate higher profits abroad than at home, but the profits must be higher as the profits achieved by domestic firms. Another study (Lall and Streeten, 1977) argues that that FDI arise because it is difficult to sell or lease the following intangible assets:

Table 1 *Advantages giving rise to FDI*

Advantage	*Description*
Capital	Larger or cheaper cost of capital than local or smaller foreign competitors
Management	Superior management in the form of greater efficiency of operation or greater entrepreneurial ability to take risk or to identify profitable ventures
Technology	Superior technology in the form of ability to translate scientific knowledge into commercial use. This involves the functions of discovering new processes and products, product differentiation and various support activities
Marketing	The functions of market research, advertising and promotion, and distribution
Access to raw materials	Privileged access to raw materials arising from the control of final markets, transportation of the product, processing, or the production of the material itself
Economies of scale	The finance and expertise to set up and operate facilities that enjoy these economies
Bargaining and political power	The ability to extract concessions and favourable terms from the host government

Source: Lall and Streeten (1977)

They find that these specific advantages are more significant the more monopolistic the industry is. These firm-specific advantages allow the firm to achieve higher profits abroad than a local firm achieves domestically. These types of advantages are connected only with the company and not to the place of its action, since the firm is the owner of these advantages and they cannot be used by other companies. This theory is mainly based on unique knowledge and it occurs only when there are adequate facilities, scientific research base, sufficient funds for its financing, progressive, marketing-specialists and consumers with high income and high education levels. As Lall and Streeten (1977) argued that it is these intangible assets which are difficult to value and transfer and which explain why a firm can compete successfully in a foreign market. However, this study failed to explain

why the firm does not utilize its advantages by producing in the home country and exporting abroad, which is an alternative to FDI.

Aharoni (1966) tried to answer this question based on the behavioral theory of the firm and argued that there are three factors affecting the initial investment decision. The three factors are *uncertainty, information* and *commitment.* Uncertainty is normally exaggerated in which case some initial force (such as the fear of declining markets) propels the desire to indulge in FDI. This leads to a search for information relevant to project appraisal. Once business executives spend time an effort on the project and if it is promising, then they will be committed to its implementation. The drawback of the industrial organization hypothesis is that it does not explain why firm choose to invest in country X rather than country Y (Moosa, 2002, p. 32).

The starting point for *the product life cycle theory* (Vernon, 1966) was the fact that the producers on the American market are better informed about the possibility of introducing new products on the market than the foreign producers. This theory assumes that a product goes through the phase of initiation, growth, maturity and decline and explains why the company exports first and then invests abroad. Petrochilos (1989) points out that this hypothesis is useful because it offers another interpretation of FDI, particularly for manufactured products that are characterized by advanced technology and high income elasticity of demand. The hypothesis argues that firms indulge FDI at a particular stage in the life cycle of the product. The following three stages are identified:

— **Phase one – Introduction of the product**. The production takes place at home (even if the costs abroad were lower than in the home country). The reason for placing the product on the domestic market results from the necessity of further adjustments to the product, which requires direct contact with researchers, designers, marketing specialists and customers. During this stage of the product life cycle the demand for the new product is inelastic and the firm can charge a relatively high price.

— **The second phase - the phase of growth**. Demand for the product continues to grow while new competition emerges. The firm resorts to FDI in foreign countries as a way to expand its business.

— **The third phase - the phase of maturity and decline.** This stage is characterized by a complete standardization of the product and its production process, which is no longer an exclusive possession of the innovative firm. The competition at local markets forces the company to move its production capacity to the next country, which is cheaper and with hope to increase the profits there.

The theory of product life cycle comes from marketing concepts and can be applied only for the initial entry of a manufacturer to the foreign market (Grazia, 2005, p. 76-79). FDI flows take place in the phases of maturity and decline as a defensive move to maintain the firm´s competitive position against its domestic and foreign rivals. Gruber et. al. (1967) found a strong association between the propensity to invent new products, export performance, FDI and the ratio of local production to exports on the one hand and R&D expenditures on the other. The association between the ratio of local production to exports and R&D expenditure is interpreted as an indication of the substitution of FDI for exports in host countries in the final stage of a product cycle. Studies also argued that the applicability of the product life cycle hypothesis is restricted to highly innovative industries (Solomon, 1978) and that it is an oversimplification of the firm´s decision – making process (Buckley and Casson, 1976).

According to *the internationalization hypothesis*, FDI arises from efforts by firms to replace market transactions with internal transactions. This idea builds on the argument which was first provided by Coase (1937) that certain marketing costs can be saved by forming a firm. Buckley and Casson (1976) suggested that markets in intermediate products are imperfect, firms have an incentive to bypass them by creating internal markets, such that the activities linked by the markets are brought under common ownership and control. The internalization of markets across national boundaries leads to FDI and this process continues until the marginal benefits and marginal cost are equal. This theory explains why firms expand abroad and why foreign direct investments are more effective than export or licenses. With regard to research of externalities it is clear that the results of the research, obtained by the company must be protected. Therefore companies keep their patents and know – how and instead of selling them, they establish branches abroad where they benefit from this knowledge as well.

There are several types of market imperfections, where internalization can help tremendously:

- Eliminates uncertainty
- Reduces time lags and transaction costs via intra-firm transactions etc.

Nevertheless, Rugman (1980) argued that the hypothesis is so general that is has no empirical content. Buckley (1988) argued that this hypothesis cannot be tested directly, because statistical tests are bound to be based on simplifying assumptions and boil down the conclusion that the process of internalization is concentrated in industries with high incidence of R&D expenditure. However, evidence shows that the pattern of FDI is broadly consistent with this hypothesis (Martin, 1991).

Another theory of market imperfections is the *the oligopolistic reactions hypothesis.* Knickerbocker (1973) found that in an oligopolistic environment, FDI by one firm triggers a similar action by other leading firms in the industry in order to maintain market shares. This oligopolistic reaction increases with the level of concentration and decreases with the diversity of the product. Lall and Streeten (1977) argued that the very structure of oligopolistic competition and equilibrium is such that none of the participants can afford to ignore what the others are doing. For example, if company A establishes a subsidiary or export base in country X, it is highly probable that some competitive threats will arise for company B:

- company A gains market share on the account of company B in country X, because company B only exports in country X (company A can save transport costs or can provide better marketing activities to the customer, because it is closer to him)
- If country X would introduce certain import restrictions, company B may lose this market
- Company A may acquire new knowledge, skills and technology, human capital due to the presence in the market in country X, which then can be used to compete in domestic and other foreign markets.

For these reasons, company B decides to minimize these risks and invests. The cost of investment can be better estimated as a possible loss from the action of company A, if company B would remain idle.

They further stated that this kind of behavior is consistent with the Marxist view of international capitalism that is "*growing worldwide battle of competing giant firms, forced to extend continually the scope of their activity*" (Magdoff 1972 and Barratt-Brown 1974). Agarwal (1980) argues that an implication of the oligopolistic reactions hypothesis is that the process of FDI is self-limiting, since the invasion of each other´s home market leads to an increase in completion and a decline in the intensity of oligopolistic reaction. This implication is incompatible with stylized facts and it fails to identify the factors that trigger the initial investment. Yu and Ito (1988) argue that firms in oligopolistic industries do not only consider their competitor´s activities but also the same economic factors as firms in a competitive industry (Moosa, 2002, p. 42).

The Location hypothesis states that FDI exists because of the international immobility of some factors of production, such as labour and natural resources. This immobility leads to location- related differences in the cost of factors of production. Horst (1972) argued that one form of location-related differences in the costs of factors of production is the locational advantage of low wages, because they are an important determinant for a decision of a firm to do FDI in the particular country (e.g. labour intensive production of MNCs such as Nike is situated China). Evidence on the hypothesis that cheap labour market attracts FDI is mixed. Riedel (1975) found relatively lower wages costs to be one of the major determinants of export orientated FDI in Taiwan. Saunders (1983), Schneider and Frey (1985), Culem (1988) et.al. found that a rise in the host country´s wages would discourage FDI flows. On the other hand other studies such as the study of Nankani (1979), Wheeler and Mody (1990) and Yang et. al. (2000) found no significant effect or even the reverse effect. Other research provided by Culem (1988), Lucas (1993), Pain (1993), Wang and Swain (1995) et al. indicated that higher unit labour cost leads to higher outward and lower inward FDI. Another factor that pertains to the labour market is labour disputes, which should have an adverse effect on FDI inflows. The adverse effect on FDI would depend on two characteristics of industrial disputes: incidence and severity. Studies which considered these variables came up with contrasting results. Moore (1993) found that FDI is related positively to the severity of a strike as measured by the number of

workers involved while Tcha (1998) found some support for the importance of this factor in determining FDI (Moosa, 2002, p. 33-36).

It is now rational to assume that MNCs prefer flexible non-unionized labour markets and when unionization is present, decentralized firm-level wage bargaining processes over centralized ones. The reason is that unionization leads to higher labour costs. The study of Leahy and Montagna (2000) on the other hand showed, that in absence of taxes (subsidies), the MNC is less likely to locate in the host country under a decentralized than under a centralized wage setting regime, despite the fact that the latter typically yields higher wages (Moosa, 2002, p. 35-36).

Locational advantages do not only take the form of low wages but are also applicable to other factors of production (e.g. a firm may indulge in FDI by building a factory in a country where it is cheap to generate hydroelectric power etc.) Capital may also be the underlying factor of production, particularly if the capital markets are segmented. The idea here is that FDI will flow to countries where the cost of capital is low (Moosa, 2002, p. 36).

Eclectic theory explains the differences between countries in the type of international activities. The author of this theory is John H. Dunning (1977, 1979, 1988) who integrated the industrial organization hypothesis, the internalization hypothesis and the location hypothesis without being to precise about the interrelation of these hypothesis. The eclectic theory tries to find an answer to the following questions:

- Why the demand for certain commodities cannot be met by local firm producing in the same country or by a foreign firm exporting from other country?
- Why a firm, if it wants to expand, does not use ways (e.g. producing at home and exporting to the foreign country, indulging in a portfolio investment in the foreign country, etc.) other than FDI?
- Why a foreign subsidiary can out-compete other potential suppliers in the foreign market and why is FDI is more profitable than other means of expansion?

According to this theory three conditions must be met before a firm engages FDI. First it has to have a comparative advantage (right to particular technology, monopoly power and size, access to raw materials etc.) over other firms. Second, it must be more beneficial for

the firm to use these advantages rather than to sell or lease them. Third, it must be more profitable to use these advantages in combination with at least some factor inputs located abroad. If this is not the case, the exports would be more suitable than FDI (Moosa, 2002, p. 37).

This theory recognizes that advantages arising from ownership, internalization and location (so called OLI Paradigm) may change over time and accepts that if country-specific characteristics are important determinants of FDI, it may be invalid to generalize from one country´s experience to another.

Jere Behrman (1972) developed a typology of FDI which attempts to explain the objective of FDI. First, *market-seeking* investment is undertaken to sustain existing markets or to exploit new markets. For example, due to tariffs and other forms of barriers, the firm has to relocate production to the host country where it had previously served by exporting. Because the reason for this type of investment is to better serve a local market by local production, market size and market growth of the host economy are the main factors that encourage market-seeking FDI. The impediments in serving the market such as tariffs and transport costs also encourage this type of FDI (Markusen and Venables 1998) Japanese FDI in automobiles in the US in late 80's is an example of this type of FDI.

Second, firms pursue strategic (*strategic asset seeking FDI*) operations through the purchase of existing firms or assets in order to protect ownership specific advantages to sustain or advance its global competitive position. In order to do so, a firm can decide to acquire a key local firm, or its local capabilities including R&D, knowledge and human capital.

Third, when firms invest abroad to acquire resources not available in the home country, the investment is called *resource-seeking*. Resources may be natural resources, raw materials, or low-cost inputs such as labour. An example is investment made by the US and Japan in export assembly in electronics in Asia in search for cheap labour. Unlike market-seeking FDI, this type of FDI is intended to serve not only the local market but also the home and third country markets. Availability of resources, cheap and skilled labour, and physical infrastructure are the main attractors of resource-seeking FDI (Kinoshita and Campos 2002).

Fourth, the investment is rationalized or *efficiency-seeking* when the firm can gain from the common governance of geographically dispersed activities in the presence of economies of scale and scope. In this respect, prospective membership of the European Union conductive to the establishment of regional corporate networks and the presence of high transport and communication costs will encourage more of efficiency-seeking FDI (Kinoshita and Campos 2002).

1.3.3 FDI Theories considering risks, policies, trade barriers, regulations and strategic and long-term factors

These theories assume that factors such as political risk, tax policies trade barriers etc. will discourage inflows of FDI. For instance, *political risk* arises because unexpected modifications of the legal and fiscal frameworks in the host country may change the economic outcome of a given investment in a drastic manner. For example, a decision by the host government to impose restrictions on capital repatriation to the investor´s home country will have an adverse effect on the cash flows received by the parent company (Wang and Swain 1995). Although the results dealing with this factor have been mixed, Schneider and Frey (1985) concluded that models encompassing economic and political factors perform better than other models that do not contain political variables (Moosa, 2002, p. 50).

Sometimes the wider concept of country risk is used instead of political risk, taking into consideration economic and credit indicators. In this case, economic factors pose economic risks because adverse developments in economic indicators (inflation rate, depreciation of the currency) can affect cash flows adversely, and hence discourage FDI (Schneider and Frey 1985, Yang 200 et. al).

In general, *tax policies* affect the FDI incentive and the means by which it is financed. There are three ways through which tax policies affect the decision of MNCs (Jun 1989):

1. The tax treatment of income generated abroad
2. The tax treatment of income generated at home
3. Tax policies affect the relative cost of capital of domestic and foreign investment

Jun (1989) argued that an increase in the domestic corporate tax rate leads to an increase in the outflow of FDI. Further empirical studies (Hartman 1981,1984; Boskin and Gale 1987 et. al.) examined the effect of taxation on the cross-sectional distribution of capital and labour and encountered difficulties in identifying the effects of taxes on the factor demands of MNCs. The reasons were that cross-sectional variation in national tax rates and tax systems may be correlated with a number of observable and unobservable factors that differ between one country and another. Furthermore, time series variation in tax rates may not be adequate to identify tax effects, since tax rates change infrequently and tax changes may be endogenous to unobservable economic conditions that affect factor demands. Finally, it is possible that the tax policy has no effect, or only a trivial effect on FDI (Hines 1996). Hines simultaneously examined the effect of international taxation on FDI and the effect of substantial taxation on business location. He argued that previous studies (Newman 1983, Bartik 1985 et. al.) had difficulty in finding any effect of state taxation on business location because of the problem of controlling for important unobservable variables. Specifically he shows that investors who cannot claim credit for state tax payments reduce their investment shares by 9-11% for every 1% rate of taxation. However, he also pointed out that it is not possible with the cross-sectional data to test directly whether tax factors are an important part of the explanation (Moosa, 2002, p. 51-53).
Scholes and Wolfson (1990) have shown that total taxes paid by foreign firms do not necessarily increase when taxes are raised in the host country. Tax reform may simply reallocate the respective amounts paid to the home and host governments (Moosa, 2002, p. 53-54).

FDI is also a way which allows MNC to circumvent *trade barriers* such as tariffs or quotas. This means that open economies without much restrictions on international trade should receive fewer FDI flows (Moosa, 2002, p. 54). According to Eun and Resnick (1998, p.394) the surge in FDI in countries such as Mexiko and Spain is attributed partly to the desire of MNCs to circumvent the trade barriers impose by NAFTA and the EU. However Wang and Swain (1995) et.al used the trade-weighted tariff rate to represent trade barriers but it turned out to be insignificant determinant of FDI. Bajo-Rubio et.al (1994) on the other hand found that the tariff rate is a significant determinant of FDI. Yang et. al. (2000) for instance used the ratio of trade to GDP as a measure of the openness of the economy and concluded that FDI is indeed used to circumvent trade barriers. Another

study (Blonigen and Feenstra 1996) investigated the threat of protectionism by the host country. The result showed that threats of protection lead to greater FDI flows.

In order to attract FDI most *governments* adopt policies (*regulations*) which are both encouraging and discouraging by offering incentives (such as tax incentives etc.) on the one hand, and disincentives (such as restrictions etc.) on the other. Other incentives for MNCs to invest could involve (Moosa, 2002, p. 55). :

- Flexible conditions with respect to local equity participation
- Low cost infrastructure, fuel and energy
- Subsidies, grants and loan guarantees
- Monopoly rights and preferential government contracts
- A framework of efficiently implemented stable FDI policies
- Tax reductions, accelerated depreciation, exemption from customs duties, investment and reinvestment allowances

According to Moosa (2002), disincentives may include also a number of impediments that may range from slow processing of required authorization to the outright prohibition of FDI in specific regions or sectors. There are also requirements such as that the MNC must employ a minimum number of local workers and restrictions involving profit repatriation. Agarwal (1980) argued that the incentives have a limited effect on the level of FDI, as investors base their decisions on risk and return considerations. On the other hand, disincentives seem to have a more definite impact than incentives on FDI.
Incentives help particularly small firms with limited experience, but their overall impact is marginal at best. It is also important to think about other factors which are more influential for the investment project under consideration. Since the objective of incentives is to correct existing comparative disadvantage of the host country, it is not surprising to find that their effectiveness is circumscribed (Reuber 1973 et. al.). It could happen that a government offers incentives for some kinds of FDI while simultaneously imposing disincentives for other kind. This is particularly the case with acquisition versus greenfield investment. Buckley and Casson (2000) investigated this and revealed in their model that the market structure is a crucial factor in the choice between greenfield investment and acquisitions. Governments prefer greenfield investment because, unlike acquisitions, it

leads to an increase in the local capacity and an intensification of competition (Moosa, 2002, p. 56-57).

One example of using incentives to offset disincentives is when the host government uses trade-related performance (TRIP) requirements, which are seen as significant obstacles. We can refer to TRIP as host government policies designed to encourage local purchase of inputs by foreign-owned firms, and policies to encourage these firms to export. The reason why the host country imposes TRIP requirements (Wallace 1990):

- They represent an explicit commitment to increasing the supply of foreign exchange
- They could be used by the host government as a defensive measure
- They can correct market distortions

Wallace (1990) further argues that while TRIP requirements are not attractive on economic efficiency grounds, they are not a significant obstacle to FDI.

Reuber et.al. (1973) stresses out following *strategic and long term factors* to be the reason of FDI:

- The need to develop and sustain a parent-subsidiary relationship
- The economies of new product development
- The desire on the part of investor to defend existing foreign markets and foreign investment against competitors
- The desire to induce the host country into a long commitment to a particular type of technology
- Competition for market shares among oligopolists and the concern for strengthening of bargaining positions
- The advantage of complementing another type of investment
- The desire to gain and maintain a source of supply that in the long run may prove useful.

Other study (Vaitsos 1976) argued that these factors have indirect, long term and wider consequences for FDI and have direct influence on the future income streams.

1.3.4 Entry mode FDI theories

These theories deal with the mode of entry into foreign markets. In the 1960s, theories of FDI concentrated on the choice between exports and FDI. In the 1970s, the internalization hypothesis identified other modes of entry into a foreign market, including licensing, franchising and subcontracting. In the 1980s, M&As emerged as an important mode of entry, and so the choice became between acquisitions and greenfield FDI (Moosa, 2002, p. 58-59). A vast body (Buckley and Casson 2000, Hymer 1960, Aharoni 1966 et. al.) of literature was concerned with the issue of advantages of FDI over exporting. Lall and Streeten (1977) tried to indentify the major factors that affect the choice of investors between exports and FDI:

- Product life cycle that triggers FDI
- Oligopolistic reaction hypothesis
- FDI enables firms to service the destination markets in better way
- FDI enables exploit cost advantages (production and transportation costs)
- Government policy in the host country with respect to trade barriers

Eaton and Tamura (1996) found that the importance of *FDI* relative *to* the *exports* grows with the population and that distance tends to inhibit FDI much less than it inhibits exports. Some studies argue that *FDI* is also preferred *to licensing* if the host country is politically stable, the technology is new and tightly controlled, the firm´s sources of power are broadly based, the absorptive capacity of the license is low and if the firm is large and more internationally involved (Baranson 1970, Parker 1974, Baumann 1975 et. al.). Other study (Buckley and Casson 1988,1996) considered joint ventures as an important entry mode. They argued that the possession of complementary assets, opportunities for collusion and barriers are conducive to the establishment of joint ventures. They also listed other factors (see Table 2) which lead MNCs to consider certain entry mode.

Table 2 *Factors which decide the entry mode*

Factor	*Effect*
An increase in transportation costs or loss of economies of scale in domestic production	Licensing and wholly-owned foreign production
Specific type of technology	Greenfield production is preferred to acquisitions and licensing
An increase in the cost of building trust	Greenfield FDI and arm's-length contractual arrangements are preferred to acquisitions
High cost of learning about the foreign market through experience	No inclination towards acquisition, licensing and franchising as well as subcontracting or greenfield FDI in distribution
High transaction costs of intermediate goods	Vertical integration of production and distribution, which can be achieved by exporting to a wholly-owned distribution facility, licensing, or a vertically-integrated joint venture
High transaction costs of arm's length technology transfer	FDI is preferred to arm's length arrangements such as subcontracting
The presence of significant monopoly rents associated with a high cost of competition	Acquisition is preferred to greenfield FDI in either production or distribution. Also, long-term arrangements (such as licensing) are preferred to short-term arrangements (such as subcontracting and franchising)

Source: Buckley and Casson (2000)

With respect to these findings they concluded that subcontracting is not a very attractive mode of entry because it does not give access to the local rival´s experience, and joint ventures in production do not make much sense as an entry mode unless the production joint venture is part of an integrated joint venture that handles distribution well.

The world Investment report (UNCTAD 2000) identified four other factors that make the choice between *FDI* and *M&As* unattainable:

1. Economic development (the more developed economy of the host country the greater the likelihood of M&As
2. FDI policy (when restrictions occur, FDI is most likely to take a form of greenfield investment)
3. Institutional factors (M&As are affected by differences in corporate governance and ownership structure)
4. Mishaps (M&A are likely to take the form of FDI when the need arises to rescue ailing companies in the host country)

Bukley and Casson (1981) presented a model that specified the optimal timing of a switch in modes of market servicing by reference to costs and other factors.

1.3.5 Other FDI theories

Four hypotheses will be discussed in this subsection:

- The Kojima hypothesis
- The hypothesis of diversification with barriers to international capital flows
- The internal financing hypothesis
- The currency area hypothesis

Foreign direct investment provides a transfer of capital, technology and managerial skills from the source of the host country according to *Kojima hypothesis* (1973, 1975, 1985). He classified FDI into two kinds. The first is trade-orientated, which generates an excess demand for imports and an excess supply of exports at the original terms of trade. This leads to welfare improvement in both countries. The second kind is the antitrade-orientated FDI, which has exactly the opposite effect to those of the first kind. It has an adverse effect on trade, and it also promotes unfavourable restructuring in both countries. His hypothesis is based on the complementarity of trade and FDI, and it emphasizes the need for considering comparative costs. Petrochilos (1989, p. 21) criticized the Kojima hypothesis and concluded that this hypothesis is not much a theory explaining FDI but more like a prerequisite for establishing foreign trade. He also argued that the elements of Kojima hypothesis can be found in other theories such as product life cycle hypothesis and

eclectic theory. Two conditions must hold for an international diversification of a firm. The first involves barriers or costs to portfolio flows that are greater than those associated with direct investment and the second involves investor´s recognition that multinational firms provide diversification opportunities that are otherwise unavailable (Agmon and Lessard 1977). They tested these propositions and found that the results are consistent with the second proposition. The study of Errunza and Senbet (1981) developed a model whereby investors demand diversification and MNCs supply diversifications services is an activity reflected positively in the price of their stocks. The results showed that there was a systematic relationship between the extent of international involvement and excess market value. Furthermore, the relationship was found to be stronger in periods characterized by the presence of barriers to capital flows (Moosa, 2002, p. 49).

The *internal financing hypothesis* (Moosa, 2002, p. 42-44) refers to the utilization of profit generated by a subsidiary to finance the expansion of FDI by an MNC in the country where the subsidiary operates (Barlow and Wender 1955). Furthermore, it implies the existence of a positive relationship between internal cash flows and investment outlays, which is plausible because the cost of internal financing is lower. The informational imperfections cause external financing to be more expensive than internal financing (Froot and Stein 1991). Another explanation why MNCs like internal financing was provided by Hartman (1985). He argues that, because repatriated earnings and not earnings of the subsidiary are typically the source of tax liability in the country, income tax should affect FDI differently, depending on the required transfers of funds from the subsidiary to the MNC. Other studies (Stevens 1969, Severn 1972) tested his hypothesis and failed to find supportive evidence. On the other hand Brash et. al. (1966) produced supportive evidence and reached a conclusion that *"the most important sources of funds required for expansion are undistributed profits and depreciations allowances"*. Reuber et. al (1973) suggested that a distinction should be made between the cash flows of the enterprise as a whole and those of the subsidiaries alone because cash flows of the subsidiaries affect new investment outlays, particularly if there are restrictions on profit repatriation. This suggestion was also empirically supported by Agarwal (1980).

The currency areas hypothesis and the effect of the exchange rate (Moosa, 2002, p. 44-48) attempts to explain FDI in terms of the relative strength of various currencies. This hypothesis postulates that firms in a country with a strong currency tend to invest abroad,

while firms in a country with weak currency do not have such a tendency. It is based on capital market relationships, foreign exchange risk and the market´s preference for holding assets denominated in strong currencies (Aliber 1970, 1971). He also argues that an MNC in a hard currency area is able, based on reputation, to borrow at lower rates in a soft currency country than local firms. If this hypothesis is valid, it would imply that an overvaluation of a currency is associated with FDI outflows, whereas an undervaluation of the currency must be associated with FDI inflows. Agarwal (1980) found some support for this hypothesis in the sense of the above mentioned implication. However, Lizondo (1991) found that this hypothesis cannot account for- cross-investment between currency areas, for direct investment in countries belonging to the same currency area, and for the concentration of FDI in certain industries. Dunning (1973) suggested that the currency area hypothesis adds to the industrial hypothesis, because country risk affects the relationship between the investing firms and their competitors, though it does not supplant it. Exchange rates are also important for FDI, because FDI can be viewed as an alternative to exports. If the domestic currency appreciates against foreign currencies, MNCs based in the home country would find it difficult to export, as domestic goods become less competitive. If the appreciation of the domestic currency persists, the MNC may find it useful to move abroad, resulting in a rise in FDI. In this case, FDI can be viewed as a measure taken to hedge economic exposure to foreign exchange risk (Agarwal 1980). Changes in exchange rates are bound to have an effect on FDI. Depreciation of the domestic currency makes domestic assets more attractive to foreigners, while foreign assets become more expensive for residents in the home country, resulting in an increase of FDI inflow (Froot and Stein 1991). Caves (1988) argued that the effect of the exchange rate on FDI runs through two channels. First, changes in exchange rates lead to changes in the investor´s costs and revenues. The net effect on FDI is ambiguous, depending on certain characteristics of the underlying business activity. The second channel is associated with expected short- term exchange rate movements. A depreciation that is expected to be reversed will encourage FDI inflows to obtain capital gains when the domestic currency appreciates. In general, various studies (also mentioned above) have produced results showing that FDI is affected by exchange rates.

This subsection presented a comprehensive survey of theory on FDI. Now that it has been dealt with the determinants of FDI, the next task is to examine its effects on the host and home countries.

1.4 The Effects of direct foreign investments on national economy

Foreign direct investments are not only a movement of financial capital but also technology and other skills such as managerial, accounting, marketing etc. Foreign direct investments have a positive impact on the national economy as a whole. It has particular effects on national income, trade and balance of payments, employment, economic structures, technology transfer, and also on political and social aspects. On the other hand, there are also disadvantages of FDIs such as the possible disturbance of the local market if there is only a weak connection to homeland economy and where the key sectors could fall into private hands of foreign investors. For instance, Kindleberger (1969) argued that one country´s disadvantages are not necessarily the other country´s advantages. He found that the relationship arising from FDI process is not a zero-sum game, meaning that both countries (home and host) must believe that the expected benefits to them must be greater than the disadvantages, because an agreement would not be otherwise reached and the underlying project would not be initiated. The effects of FDI on the host country can be generally classified as (Moosa, 2002, p. 69):

1. Economic – include implications (macro, micro) for economic variable such as output, balance of payments and market structure
2. Political – include question of national sovereignty (MNCs may jeopardize national independence)
3. Social – are concerned with the creation of enclaves and foreign elite in the host country, as well as the cultural effects on the local population.

Now, the economic effects will be mainly discussed on the following section.

1.4.1 Economic Effects of FDI

— **The impact of FDI on output and economic growth**

One of the most important factors of FDI is its effect on output and therefore the economic growth in the host country. Foreign investor contributes to the host country's national income by adding some value to the inputs and generates profit which is taxed. To quantify the impact of FDI on national income the following formula can be used (Root, 1990, p.657):

$$\text{Net Revenues/Costs of FDI} = \frac{(F + R' + T) - N + L}{E}$$

- FDI - Foreign Direct Investment
- F-payments for production factors
- R'-profit after tax
- T - income tax
- N - the cost of lost opportunities for local production factors
- L - indirect benefits (difference between market externalities)
- E - Payment for foreign production factors used by foreign investors

If the value is greater than one, then the benefits are greater than the cost of a given foreign investment. This is beneficial for the host country´s national income and economic growth. Foreign investments are additional sources of capital in terms of quantity and quality and thus affect the country´s economic growth and efficiency. The majority of theories of economic growth and development focus on the increase in real per capita income and relate this increase to certain major factors such as capital accumulation, population growth, technological progress and the discovery of new natural resources.

Multinational corporations affect the economical growth for at least three reasons. First, the MNC´s activity may lead to a lower rate of accumulation domestically because a proportion of the profits generated by this activity is repatriated rather than invested in the host country. Second, the MNC´s may affect the market structure adversely, making it less competitive. Third, the MNC`s presence may lead to some adverse developments, such as

a greater incidence of undesirable practices (e.g. derogatory pricing) or weaken the control over economic policy (Lall and Streetan 1977).

Borensztein et.al (1995) tested the effect of FDI on economic growth in a cross-country regression framework, utilizing data on FDI flows from industrial countries to sixty-nine developing countries over two decades and suggested the following conclusions:

1. FDI has the effect of increasing total investment in the economy more than proportionately, which suggests the predominance of complementarity effect with domestic firms.
2. FDI is an important vehicle for the transfer of technology, contributing relatively more to growth than does domestic investment.
3. For FDI to produce higher productivity than domestic investment, the host country must have minimum threshold stock of human capital (Moosa, 2002, p. 75).

Another study (Feldstein 1994) examined the effect of outward FDI on the national incomes of the home and host countries in the presences of taxes and tax credits. He argued that the national income of the home country depends on the relative importance of the loss of tax revenue to the foreign government and the increased use of foreign debt. Firms that invest abroad pay taxes on profit of their foreign subsidiaries to the governments of the host countries, which means that one consequence of outward FDI is the loss of revenue by the home government to the host government. But why would firms increase their foreign borrowing as they expand their FDI? Feldstein (1994) answered this question with following reasons:

- Such borrowing is one way to hedge the value of foreign profits caused by fluctuations in exchange rates
- There may be some restrictions on the amount of domestic taxable income when they have overseas operations
- Firms may be able to borrow at a lower cost in countries where collateral is available
- Local debt can be used as an anti-expropriation device

Irrespective of the relative importance of these factors, foreign borrowing is useful as long as the real after-tax cost of foreign borrowing is less than the after tax return on the foreign assets acquired with these funds. The evidence Feldstein presented shows that the favourable leverage effect is likely to outweigh the loss of revenue to the foreign country (Moosa, 2002, p. 75-76).

— **Impact of FDI on balance of payments and trade**

In general, FDI is often blamed for its balance of payments effect. For instance, the investing country faces a sudden deficit when FDI occurs, while the host country faces a small perpetual deficit as a result of profit repatriation. It is clear, that a profitable FDI project with profits repatriated in foreign currency must result in greater balance of payments outflow than a similar project financed locally.
Types of financial flows and their impact on the host country's balance of payments are reflected by the following table (same movements show opposite effects on the home country's balance of payments), (Ferenčíková, Michník and Šesták 1997, p.49).

Table 3 *Financial flows and their impact on the host country´s balance of payments*

Type of the financial flow	**Effect**
Loans from parent country	Positive
License fees and technology fees	Negative
Management and know-how fees	Negative
Payments for imported services and production factors	Negative
Increased exports from the host country	Positive
Payments for the purchase of business shares	Positive
Dividend interest payments	Negative

The effect of FDI on the balance of payments can be also expressed mathematically. Positive impact (revenues) is reflected by the sum of (Root, 1990, p.662):

$$K+X+S$$

— K - Initial inflow of investment capital

- X - export of the subsidiary
- S - The import-substitution, which is manufactured by the subsidiary (import substitution).

The negative impact (cost) on the balance of payments is shown as the following sum:

$$(R´´+F) + (M+M´) +D$$

- R"- repatriated profits
- F - Payment for foreign production factors
- M - Imports of a subsidiary
- M´- import induced by an increase in revenue
- D - Disposal of a subsidiary (sales)

These effects are defined by the basic macroeconomic equation:

$$X- M = GNP – (C+I_d+G)$$

- X – Export
- M - Import
- GNP - gross national product
- C - Consumption of individuals
- I_d - gross domestic investment
- G - Government spending

The above equation shows that if export is higher than import, then GNP exceeds the amount ($C + I_d + G$) by the same amount. Foreign direct investments will improve the balance of payments, if their influence on the growth of GNP is not beaten by a higher growth of ($C + I_d + G$). In the long run the consumption grows as fast as GNP, meaning that investments have a neutral overall impact. In the short term there may be an increase in imports of goods and services related to the activities of the subsidiaries, which may cause a deficit.

The balance of payment effects can be summarized as follows:

- Direct and indirect balance of payments effects
- Initial effect
- The export, import substitution, import and remittances effect

The direct effect is reflected immediately in the foreign exchange gap, which results from the flows associated with the investment. The drawback is that it does not show what would have happened had the foreign investment not occurred. On the other hand *the indirect effect* does not give an idea of the effect of FDI on the balance of payments via domestic sales and the use of local.
The initial effect leads to an improvement in the capital account of the host country by the amount of the investment less the value of any imported machinery.
The export and import substitution effect lead to an improvement in the balance of payment whereas *the import and remittances effect* lead to the deterioration of balance of payments.

Certain concerns have been expressed over the effect of FDI on *trade* (Moosa, 2002, p. 84-86). It may appear that MNCs are trade-intensive firms, this is more a reflection of the activities which they indulge rather than their own behaviour. MNCs export fewer engineering products than do domestic firms (Solomon and Ingham 1977). Another study (Goldberg and Klein 1997), on the other hand, showed that FDI directed in to developing countries affects their trade flows with industrial countries even after controlling for the effect of the exchange rate.
The most critical issue about the relationship between FDI and trade is whether they are complements or substitutes. To put it differently, the question is, why MNCs establish subsidiaries in a foreign market to replace or help to increase export to the same market? There may be several reasons such as:

- Choosing the most favourable entry mode
- Stimulating exports
- Establishing a larger distribution base etc.

Other theories argued that whether trade and FDI are complements or substitutes depends on whether FDI is horizontal (Markusen 1984) or vertical (Helpman 1984). I countries have significantly different factor endowments, than vertical FDI dominates. On the other hand, horizontal FDI dominates if countries are similar in size and relative endowments, and if trade costs are moderate to high. In horizontal FDI, firms serve foreign markets by setting up plants there to provide identical goods (Markusen 1984). Exports from the source country to the hot country will decline, implying that they are substitutes. In vertical FDI, MNCs separate different production stages geographically across countries to take advantage of lower factor prices (Helpman 1984). Specifically, the unskilled-labour-intensive stages of production are located in a low wage country. In this case there will be an increase in the exports of final products from the cheap labour country (host country), while there is also an increase in the exports intermediate products by the MNC (source country) to the host country where the subsidiary is located. FDI are considered here as complements. We can therefore conclude that the relationship between sales of MNCs and the volume of trade are important which is also supported by the empirical evidence in a mixed way. Some studies (Lipsey and Weiss 1981,1984 et.al.) based on cross-sectional industry and firm level data indicate a positive relationship and other study (Pain and Wakelin 1998) which considered a time series relationship between manufacturing exports and FDI for eleven OECD countries came up with mixed results. The reason why the results were mixed refers to the horizontal of vertical FDI (Amiti et. al. 2000).

— **Impact of FDI on Employment and wages**

As Keynes (1936) already found there is a relationship between investment and employment. However, the views about the effects of FDI on employment diverge among economists. For instance Baldwin (1995) argued, that FDI is capable of increasing employment directly, by setting up new facilities or by stimulating employment in distribution. Furthermore, he found that FDI can preserve employment by acquiring and restructuring ailing firms but at the same time FDI can reduce employment through divestment and the closure of production facilities. Another study of Vaitsos (1976) analyzed the effects of MNCs with reference to four factors such as scale, concentration, foreignness and transnationality and found that overall employment effects of the activities of MNCs on the host countries had been relatively small. Tambunlertchai (1976) evaluated

the contribution of foreign firms to the host country with regard to the national income contribution, employment, utilization of national income and earnings and savings of foreign exchange. His evidence suggested that FDI was unable to render a significant contribution to the host country in terms of these criteria because of high capital intensity and import dependency (Moosa, 2002, p. 77-78).

A related issue is the effect of FDI on relative wages. Feenstra and Hanson (1995) analyzed the increase in the relative wages of skilled workers and linked the rising wages to capital inflows inequality, whose effect was to shift production towards relatively skill-intensive goods, thereby increasing the relative demand for skilled workers. They also examined the impact of FDI on the share of skilled labour in total wages. Their result suggested that growth in FDI is positively correlated with the relative demand for skilled labour (Moosa, 2002, p. 80).

Foreign direct investment leads to an increase in wage inequality and the use of relatively more skilled labour by local firms according to the study of Driffield and Taylor (2000). While there is a general agreement on the proposition that relative wage changes are caused by an increase in relative demand for skilled labour, economists do not agree with this reason with following explanations:

- Advent of information technology has caused firms to switch towards production techniques that are biased in favor of skilled labour (Lawrence and Slaughter 1993, Berman 1994 et.al.)
- An increase in import competition from low-wage countries has shifted resource towards industries that use skilled labour relatively an intensively (Leamer 1993, Borjas and Ramey 1993).

After considering these issues of the effects of FDI on employment a conclusion can be derived, that is, while FDI may have positive employment effects under certain conditions, it can certainly have negative effects on employment and industrial relations in the host country.

Foreign direct investment affects the economic structure of the host country in two ways:

- Impact on the competitive environment

— Impact on sectoral and regional structure

With respect to the *competitive environment*, the foreign investor seeks to achieve a dominant market position in the host country, which creates a conflict. It is for this reason that the maximum share of foreign investors in the industry or company is often limited, especially in terms of privatization. On the other hand this situation tends to increase the competitive pressure on the market and market forces domestic firms to increase the quality of their production.

In regard to the *sectoral and regional structure* there may be a negative creation of dual economic structure, where two parallel "markets" will occur. On one hand there will be an underdeveloped domestic economy and on the other hand, a modern sector owned by foreign entities, even though, an economy with the right connection between those "markets" can also benefit from side-effects and multiplier effects of foreign investment. Foreign direct investments positively affect the economic structure by facilitating technology transfer between countries, transfer of know-how and managerial experience.

The regional structure of foreign direct investment is influenced largely by the tax policy and incentives, which seeks to attract investors into the selected region. Very often, the host government attempts to create a positive image in the public eyes by choosing the region of foreign direct investment. Despite all declared areas, the most important factors for investors are the facilities, infrastructure and availability in individual regions and because of these factors they always concentrate their investments in appropriate locations in the host country.

— **Impact of FDI on technology**

The interaction between FDI and technology is considered to be of great and critical importance (Segerstrom 1991 et.al). This is because technology is believed to be a vital source of economic growth, capital accumulation, trade and even changes in the organization of social relations and the relations of production. The main issue with respect to these aspects is how foreign technology transfers to and is absorbed by the host country

and how it affects that country´s economy (Moosa, 2002, p. 86-87). Therefore OECD issued following guidelines which should insure that MNCs:

- ensure that their activities are compatible with the technology plans of the host countries
- license technology on reasonable terms and conditions
- develop ties with local universities and research institutes
- address local market needs in an exercise pertaining to technology
- adopt practices that allow the transfer and rapid diffusion of technology

Technology is the product of R&D which aims to invent a new product or techniques of production and confers an advantage to its owner. In the case of new products the advantage comes in the form of monopoly power (Johnson 1970).

If FDI cannot take place for whatever reason, the transfer of technology can take place through a variety of channels, including import of high-technology products, adoption of foreign technology and acquisition of human capital through international study. Knowledge transferred from the MNC to its subsidiaries may leak out to the host country which will cause an externality known as the spillover effect from FDI (Moosa, 2002, p. 87). One could think that FDI plays an important role in the technology diffusion, but the study of Lall and Streeten (1977) doubt this proposition. They consider the appropriateness of technology with respect to the products that are made with the technology transferred and to the factor endowments of host countries. They further argue that even if the appropriateness of the technology is disregarded, the role played by MNCs and FDI in the transfer of technology may be limited because there are several source of technology besides MNCs (e.g. small consultants who are not interested in FDI). Other reasons are that FDI may not be the only way of acquiring technology from an MNC; the relative importance of MNCs in transferring technology depends on several factors, including the commercialization of the technology; the price set for the transfer of technology depends on the form of transfer and the bargaining skills of parties. In recent years the bargaining power shifted in favour of MNCs (Narula and Dunning 1999) because they are very skilled and powerful negotiators (Winters 1991).

Furthermore, it was also argued that the greater the extent of competition, the greater will be the transfer of technology, from the MNC to subsidiaries and this is likely to leak out to

the local firms. This means, that a high technology gap with a low degree of competition prevents spillovers (Wang and Blomstrom 1992). It also seems that domestic competition rather than competition from imports affects spillovers from FDI. Therefore a conclusion can be made, that the technology transfer is by no means certain or it will exact a price (Moosa, 2002, p. 90).

— **Impact of FDI on productivity**

The productivity is likely to rise and unit cost is likely to decline if FDI is export-promoting, and if the underlying conditions and policies allow the installation of plants designed to achieve full economies of scale and vice versa productivity will be low if FDI is import-substituting and the size of the market is too small to allow the installation of the optimum plant size (Petrochilos 1989). The productivity is also linked to the technology diffusion (Moosa, 2002, p. 86).

— **Impact of FDI on market structure**

The entry of a foreign subsidiary into local markets can force more active rivalry. This is because FDI is thought of as a vehicle for disseminating the transfer of technology, including a higher level of technical efficiency (Caves 1971, 1974). Kindleberger (1969) also suggested in his study that the main impact of FDI is widening the scope for competition. This is because it is typical that foreign subsidiaries, backed up by strong parents, can compete effectively with local oligopolists and break the latter´s grip on the local market. He argued that by reducing monopolistic or oligopolistic distortions, FDI can improve the allocation of resources in the host country. On the other hand Reuber et.al (1973) warned that the entry of foreign subsidiaries may raise the level of concentration in the host country because their presence might exert pressure for mergers among local firms. According to Lall and Streeten (1977) MNCs may induce very high degree of oligopolistic concentration, imposing diminished price competition. Newfarmer and Mueller (1975) also supported the proposition that the entry of MNCs speeds up the process of oligopolization (Moosa, 2002, p. 92-93).

— **Impact of FDI on the environment**

Because MNCs have significant financial, political and negotiating power, they could get away with causing a lot of damage to the environment, particularly in countries which desperately need to attract FDI. Some studies were conducted on the environmental effects of FDI without reaching a proper conclusion on whether FDI is good or bad for the environment. A publication of OECD (1999) dealt with the effect of FDI on environment and explored the role of host countries in developing and implementing coherent policies to ensure that proposed projects are environmentally sound. Conclusions reached in this publication were that FDI is good for the environment in developed countries but it is bad for the environment in the developing countries. OECD therefore issued some guidelines as to how MNCs should tackle environmental issues. It should encourage MNCs to provide information on the potential environmental impact of their activities; maintain contingency plans for preventing, mitigating and controlling serious environmental damage; consult with communities affected directly by the environmental policies (Moosa, 2002, p. 93-94).

1.4.2 Political Effects of FDI

From the political perspective the literature deals with risks which are entailed by foreign direct investment. The reason for these concerns is the creation of economic and later political dependence on the investing country. This view is indeed legitimate when we realize that most foreign direct investment are done by multinational companies, whose economic power and political influence are undeniable. Mainly because of these reasons there is concern about loss of national autonomy and a limitation of independent policy. On the other hand, in globalization times such as these the sovereignty is put aside.

1.4.3 Social Effects of FDI

Naturally, social issues are more likely to occur, when there are significant economic, social and cultural differences between the investing and host countries. The main social issues with regard to FDI could arise from:

- The implementation of a new culture
- Different life style
- Society differentiation

Direct foreign investment should contribute to the economic growth of the host and home country and from this perspective, it is necessary to create positive political and social aspects.

2. Foreign direct investment in the Slovak economy

The Slovak economy, for decades centrally controlled, went through a difficult path of economic transition during 1990s and 2000s that gradually created favorable conditions for foreign direct investments. These investments have had a big influence on the undercapitalized Slovakia.

My aim in this section is to give the reader an overview of the transition process in Slovakia, highlight the importance of the state policy and its legal implications towards foreign direct investments and also point out why there was, and still is, an inflow of foreign direct investment in Slovakia. Certain problems with the FDI inflow in Slovakia will be also mentioned and discussed.

2.1 Overview of the transition process in Slovak republic during 1989-2010

The international socio-political developments in 1989 hit the entire Eastern Europe, where there was a fall of communist regimes and of course it hit the former Czechoslovakia (Czechoslovak Socialist Republic) as well. After 1989 the new Czechoslovakia (Czechoslovak Federal Republic) was founded and today's Slovakia was part of it.

This subchapter will focus on the process of transition, its forms and dynamics. It is important because it led to following changes for an investor (Ferenčíková, Michník and Šesták, 1997, p.49).

1. Investors gained access to new previously unoccupied markets
2. The process of privatization led to an initial product oversupply (in comparison with developed countries), which might have benefited new projects which needed capital, modern technology, manufacturing, commercial and financial know-how, etc.

The transition of the economy was not easy because the concept of a so-called shock therapy (very quick transition to a market economy, which was affected by the

liberalization of prices, efficient fiscal and monetary policies, internal currency offsets, liberalization of foreign trade, rapid and extensive privatization) was applied.

1990-92: Early transition within Czechoslovakia

The transition began in Slovakia already in the former Czechoslovak federation *during 1990-1992*. In November and December 1989, after a series of massive demonstrations and a general strike, the Communist Party of Czechoslovakia gave up power. The parliamentary election of June 1990 produced a clear majority in both parts of Czechoslovakia for parties that expressed pro-Western orientation and liberalization of the economy. During the second half of 1990, the federal government prepared a blueprint for rapid liberalization of prices, wages and trade in January 1991, to be followed by rapid privatization. The privatization of state property was dived into *small scale privatization* and *large scale privatization* and was characterized by the following four stages (Beblavy, 2009):

1. Restitution of many small ownership units, which were nationalized or confiscated by communists (service, small manufacturing companies, real estate), to the original owners or their descendents
2. small-scale privatization, whereby small retail outlets and other small-scale enterprises were sold rapidly, generally using an auction
3. Voucher privatization used to privatize industrial and other large companies.

The aim of a **small scale privatization** was to create optimal conditions for small and medium enterprises. Only the citizens of former Czechoslovakia were allowed to participate in a small scale privatization in order to avoid the possibility of selling the assets to more solvent foreign buyers. Small privatization was carried out in the form of Dutch auctions. It finished in March 1994, when Slovakia was already independent. Acquired resources went into the state budget in the amount of approx. SKK 12.3 billion (ca €371.3 million).

Large scale privatization was dominated by sale of assets of large companies operating in the Slovak Republic, where also foreign investors could enter.

This kind of privatization has been carried out in several forms:

- Direct sale
- Public auction
- Tender

Large-scale privatization process was essentially complicated in terms of acceptance. A so called *voucher privatization* form was used to transfer the state property into the hands of small investors. The advantage of this privatization was a relatively good degree of transparency and social justice. The problem was that this method did not generate sufficient investment resources for businesses. The main part of the first round of the voucher privatization (1992) has led to a transfer of ownership of approximately SKK 80 billion (ca. €2.41 billion) into private hands. A total of 678 state-owned enterprises were privatized in the book value of SKK 169 billion (ca. €5.1 Billion). After the change of governing powers (1992), the whole process of privatization was suspended due to a change of attitudes to the voucher privatization.

The economic hardship following the transition to Slovakia's independence led to a situation where most elites and the general population declared support for the continuation of the federation, but were unable to find agreement on the precise form. This was experienced clearly both before and after the parliamentary elections of 1992, which revolved primarily around the issues of identity and economic reform. Czechoslovakia was therefore dissolved primarily because it was the only solution that both sides, in the end, were willing to accept. However, the break-up occurred in a negotiated way and with strenuous attempts by both side to minimize economic fall-out (Beblavy, 2009).

1992 – 1998: Independence and the stalled transition

On the January 1, 1993 new independent Slovak Republic was formed and Slovakia began to implement a fully independent economic policy. In the first two years, Slovakia underwent painful adjustment, due to the loss of fiscal transfers from Czech Republic, low credibility of the new country in international financial markets and the continuation of

economic downturn caused by the decrease in trade with Czech Republic. The results of these events mirrored at the end of 1993 in 3, 7% decrease of the real GDP.

The second wave of privatization (1994) started. The strategy focused on selling the large industrial enterprises, especially those in the chemical, oil and paper industry as well as metallurgy that formed a backbone of the Slovak economy through their export earnings. The beneficiaries were domestic investors, with dominant shares of top managers and/or businessmen with close political ties to the government. The avowed aim was to create a domestic business/investor class that would restructure the economy and take it forward. In reality, nearly all the major enterprises were later resold to strategic foreign investors either voluntarily or due to insolvency (Beblavy, 2009).

The Slovak economy was able to take advantage of recovery in its main export markets of the EU and the Czech Republic and export-led growth climbed to nearly 5% in 1994 and nearly 7% in 1995. The recovery was based on the ability of many Slovak enterprises to supply intermediate manufacturing inputs and simple goods for OECD markets, which are both highly cyclical (OECD 1999). This upswing was supported by newly established macroeconomic stability, with an inflation rate under 10%, and a lower structural fiscal deficit. The fiscal deficit was in the range between 5 and 10% of GDP during the 1996-1998 period and the current account moved from a surplus of 2% of GDP in 1995 to -10% of GDP in 1996, where it remained until 1998 (Beblavy, 2009).

Other attempts to stimulate growth in output, employment and provide stability were developed by the government and the central bank during 1995 – 1998. The government used state-controlled utilities to keep prices significantly below cost recovery levels and state-controlled banking sector to lend infrastructural projects as well as to keep privatized enterprises afloat. The central bank tried to provide price stability by preservation of a fixed exchange rate and low inflation, leading to only gradually appreciating real exchange rate (less than 10% between 1995 and 1998). Overall, the strategies initially did work with respect to inflation and output, but not employment. As already mentioned, inflation remained moderate – between 5 and 7%, real GDP grew by nearly 7% in 1996 and 4.2% in 1997. Employment, however experienced strong 3.6% growth in 1996, but began to decline in 1997 and would not start to grow again until 2001. However, the model was not sustainable either at the macroeconomic or microeconomic level. At the microeconomic level, privatization to domestic investors was not followed by vigorous restructuring, the ability to capture new markets or otherwise grow. State ownership and political

management of the banking system meant misallocation of capital, while absence of foreign direct investment contributed to stalling of microeconomic change. The political problems during the years 1994-1998 led to the exclusion of Slovakia from OECD, NATO and also EU did not plan to start negotiations with Slovakia. At the macroeconomic level, the very high twin deficit and extremely high real interest rates slowed down gradually the domestic economy. After trying to stave off depreciation for several weeks, the central bank capitulated on October 1, 1998, and floated the currency. This was accompanied by a widespread industrial collapse, in which unemployment shot up by nearly 4 percentage points in just 1 quarter.

1998-2002: Cleaning up the economy

The years 1998-2002 were characterized by a sharp economic slowdown, rapidly rising unemployment, a full-blown macroeconomic crisis including unsustainable external deficit, a loss of exchange rate peg, and extremely high fiscal and quasi-fiscal deficit as well as a (near-)bankrupt state banking sector in the first half of this period. GDP growth dropped from more than 5% in the third quarter of 1998 to negative figures in the last quarter. In the year 1999, the growth was in the negative territory and unemployment continued to grow rapidly, however by the end of this year the economy began to recover with growth oscillating around 4% annually and the unemployment declining (Beblavy, 2009).

By 2002, macroeconomic stability was restored together with vigorous if not extremely impressive economic growth. Banks and utilities were restructured and mostly privatized. These changes started with the election of new government in 1998, which introduced a new policy of stabilization and rapid structural reforms. Large state-owned banks, technically insolvent by 1998, were consolidated and privatized, together with many utilities. The corporate income tax was cut from 40% to 25% in several steps. The government embarked on improvements in the legal environment, with overhauls of bankruptcy and corporate governance. The government took vigorous steps to attract foreign capital, both via privatization of banks and network industries, but also through greenfield industrial projects. The new government also attempted several ambitious structural reforms to improve efficiency of public spending and sustainability of the public

finance. These reforms aimed at the pension's area and education. However, due to political between the government parties, the final versions were often either not approved or approved in a form, which was not likely to achieve the required result.
Slovakia became member of OECD in 2000, 5-6 years after its Central European neighbors. It also joined the EU accession track from which it had been previously excluded, however the process was not completed in this period. Therefore, the 1998-2002 period can be seen as a period of catching-up and cleaning up the economy. However, many structural problems underpinning the previous economic problems were not yet solved, particularly public sector efficiency problems (Beblavy, 2009).

2002-2006: Completing the transition – structural reform and EU accession

The economic picture improved continuously from the low point in late 1999/early 2000 on. Also the government continued and built upon the privatization and deregulation policies of its predecessor in areas such as banking and utilities as well as the business environment. The average growth reached 6%, accelerating from less than 5% at the beginning to 9% by the end and was driven primarily by massive FDI inflows, particularly in the automobile, electronics and engineering industries. These inflows together with EU funding after 2004 fueled construction and household consumption boom.
However, the key ingredient was the attention paid to fiscal consolidation and far-reaching structural reforms aimed at both short-term improvements in the fiscal deficit and assuring long-term fiscal sustainability. Thanks to the structurally based fiscal consolidation Slovakia met the Maastricht criteria for euro zone and entered the ERM-II mechanism in November 2005 to prepare itself for the euro adoption in 2009 (Beblavy, 2009).

The reform package of 2004, which intended to improve the efficiency and effectiveness of public spending, long-term growth and long-term sustainability of the public sector, contained following key parts:

- Tax policy
- Social policy
- Education

Slovakia was among several Central and Eastern European states that implemented the concept of *flat tax of 19%,* which was unique in itself. According to Beblavy (2009) *the flat tax needs to be understood in political as well as economic terms. It was an attempt to package pro-investment and pro-employment policy in simple and politically attractive terms. In this respect, it succeeded greatly, particularly with foreign investors despite the continuing complexity of tax administration (as revealed, for example, by continuing very bad rankings of Slovakia in the World Bank Doing Business reports).*

In social policy, the government focused on employment growth and pension reform. Policy-makers believed that, in the presence of rapid economic growth, "*incentives posed by social policy and flexibility of the labour market are also important*" for employment (MoLSAF, 2003a, p. 1). With regard to pensions, the government's view was that "*The main problem of the current system for funding pensions in Slovakia is the domination of the public pay-as-you-go pillar. This system is unsustainable in its current form*." (MoLSAF, 2003b, p. 1) This led to restructuring of the 1st (pay-as you- go) **pension pillar**, with the following key changes:

- increase in the pension age from 60 for men and 53-57 for women to 62 years of age
- introduction of more actuarial approach to the pension calculation with pensions closely reflecting contributions at the individual level
- review of disability rules and existing disability pensions

The *healthcare reform* was a two-stage process. The first stage, undertaken primarily in 2003, focused on slowing down expenditure growth by one-time measures –introduction of small fees for doctor visit, hospital stays and drugs as well as changes in drug reimbursements for drug companies. The second stage, originally supposed to start in 2004 with the other reforms, but ultimately delayed until 2005, brought a fundamental overhaul of the healthcare system. All hospitals were to be corporatized and restructured (and some even privatized), insurance companies were to become profit-seeking health management organizations, insurers and providers were to freely negotiate prices and quantities, the government was supposed to clearly determine the extent of the free healthcare package and the co-payments for diagnoses not in it and a strict hard budget constraint was to be

introduced for all actors involved. However, this reform was never fully carried out due to lack of majority at the voting in parliament and because the measures were not implemented by the time a new *social* government took over (Beblavy, 2009).

Education reforms were characterized by significant restructuring progress with of the primary and secondary education network, much less so in higher education. Primary and secondary schools transferred ownership to municipalities and regions together with a new funding formula based strongly on the number of students. In higher education, the 2002-2006 period was the one when the impact of the 2002 Higher Education Act played itself out. Since the act introduced a funding system relying on the number of students as the primary criterion and was accompanied by substantial though gradual increase in public funding, enrollment in Slovak universities exploded from 140 thousand in 2002 to more than 200 thousand in 2006. However, this development was overshadowed by two others – rising concern about the quality and the unsuccessful attempts by the government to introduce tuition fees (Beblavy, 2009).

2006- 2010: Distributing the fruits of growth - rupture or continuity?

The 2006 election meant a wholesale change in the composition of the government, with all government parties moving to the opposition and vice versa. Under the new government, economic growth accelerated to 10% and kept Slovakia among the fastest growing EU countries during the whole 2006-2008 period. Employment growth continued steadily, with macroeconomic stability retained and accompanied by low inflation. From an economic point of view, three topics dominated the public debate between 2006 and 2010:

- the social "face" of the Slovak economy
- fate of the structural reforms undertaken by the previous government
- the planned adoption of euro in January 2009

With regard to its social "face", the new government has pursued a strategy of vigorous protection of households against negative shocks combined with selective new initiatives. The selective new initiatives contained Christmas bonuses for pensioners, increase in the

one-time payment to parents of the first child, introducing lower VAT for drugs and books and abolition of patient fees introduced previously. All of the measures have been highly popular and, despite their modest fiscal and redistributive impact, politically effective. The *social* government continued with this strategy till 2010, leaving a big deficit behind for the new mid-right government (Beblavy, 2009).

As mentioned before, also the healthcare *reforms* planned by the previous government in the period 2002-2006 were revoked due to more socially orientated government. The social government also reversed policies concerning the labour market and pensions (making the 2nd pillar voluntary rather than mandatory for market entrants). In education, the government introduced tuition fees but only for part-time student, a policy step rejected by the previous government as discriminatory. *The biggest rupture has been on the privatization front where the new government has not only sharply criticized the previous one for sales of utilities; it also cancelled all incomplete transactions and blocked any further privatization. Instead, the government turned to exploration of public-private partnership and public investment. The PPP is particularly salient for road infrastructure where major routes in the network are expected to be completed using the method as a part of the government bid to accelerate construction of the Bratislava-Košice and Bratislava-Banská Bystrica corridors* (Beblavy, 2009).

Regarding the decision of previous government to *adopt euro* was also implemented in the policy of the social government and also successfully realized.

More detailed description of the progress in FDI an industrial policy will be discussed in chapter 3, which presents the development of FDI in Slovakia during the years 2000-2010.

2.2 Key elements of state policy towards FDI

State policy in relation to foreign direct investment plays a key role because it creates conditions for the inflow of foreign investment into the Slovak economy. During the permanent drawback of domestic capital, foreign capital inflows have an irreplaceable significance. Therefore, the key elements of public policy have enormous significance in terms of positive effects on regional policy, tackling unemployment, etc.

The Government of the Slovak republic committed to improve conditions, which will encourage investment, while maintaining the continuity of the received state aid rules with emphasis on the support for investment projects, projects with higher added value, developing industrial zones as a tool for reducing regional disparities. One of the tasks of the program statement is an assessment of the effectiveness of state aid in the form of investment incentives in relation to regional and economic development of Slovak Republic.

The decisions in terms of foreign investment incentives are solely made by the government and the Ministry of Economy. For this purpose a contributory organization SARIO (Slovak Agency for Investment and Trade Development) was established by the Ministry of Economy, which is financed from the state budget.

Strategic Objectives of SARIO (SARIO, Agency profile 2010):

- Applying an effective framework for the support of foreign investors and increasing the portion of investors with high value-added production.
- Supporting such export activities of Slovak enterprises that would significantly increase the turnover of Slovak foreign trade.
- Qualified and effective administration of EU Structural Funds, which provide support for activities within the framework of Foreign Direct Investment and Foreign Trade (infrastructure development, intensification of international cooperation, and image-building of the Slovak Republic).

Key activities of SARIO (SARIO, Agency profile 2010):

- creating a suitable investment and “business-friendly” environment in Slovakia;
- supporting investment projects of domestic and foreign investors and providing all necessary ancillary services;
- providing consultancy and finding solutions regarding individual state aid to investors;
- searching for and database-creation of available premises;

— providing assistance as far as creation of joint-ventures between Slovak and foreign companies is concerned;
— assisting small and medium sized enterprises in their search for export and trade opportunities abroad;
— Assisting local authorities, small, and medium sized enterprises with their application for EU Structural Funds' Grants (within the jurisdiction of SARIO) and helping them with the implementation of their projects.

In this context there are currently three areas of concern:

— Acquisition of FDI
— More efficient use of the associated benefits and issues with the appropriate guidance
— The control of multinational companies

The acquisition of FDI into the country can be implemented in various ways (OECD, 2003, p. 7- 36):

— The liberalization of market entry and establishment of operations of foreign entities without any specific measures
— Focusing on specific activities and technology
— Leaving investors some space for dealing
— Increasing the quality of investment environment

The country is economically attractive because of its affordability as a location for investors of various types. Investors focused on new markets have high requirements regarding the potential market size and its further development. On the other hand, there are also investors focused on obtaining new resources and who are particularly interested in quality and quantity. Another type of investor seeks to increase the effectiveness of their activities and considers the competitiveness of the environment in terms of its potential as an export base.

Because of these factors, and also due to the increasing competitive battle between countries for foreign direct investment, investors are much more selective.

Typical measures of a country to attract foreign direct investment are (OECD, 2003, p. 7-36):

- *Removal of FDI conditions* by eliminating the factors, which limits the entry and establishment of foreign business operations and activities of these enterprises. Major areas of concern in regard to this step is the determination of the investment types, which suppose to be covered by the liberalization measures and investor protection schemes
- *Improving the conditions for foreign investors* by providing equal treatment on the domestic level or other foreign investors. The most important issue here is the degree of equal treatment of foreign investors in relation to domestic companies, while entering the host country.
- *The protection of foreign investors* by providing certain compensation rules in case of nationalization or expropriation of assets and guarantees at the transfer of assets. A key issue is the extent of the nationalization or expropriation of property. Another problem is the acceptability of proposed methods for foreign investors. Finally, the third problem relates to the authority of the country to impose such capital restrictions in order to protect the national economy.
- *Encouraging the entry of FDI* with certain measures to improve the perception of the country in the world by providing information on investment opportunities, providing incentives tied to specific locations; facilitate the entry of FDI, improving administrative procedures and providing official services in the after-investment stage. Most of these measures are the responsibility of the host country, but some can be also provided by the investing country. Major problems include the manner of how financial, fiscal and other incentives (including the various concessions and exemptions from the legislation) are used by the investing countries to promote FDI flows to developing countries.

Even these measures are not sufficient and do not guarantee that the Slovak Republic is able to economically exploit the potential of foreign investment. However the constant

application of appropriate public policy may lead investors to implement measures, which will enhance the economic effects of FDI (the development of local capacities, use of local suppliers, improving the qualifications of the domestic workforce, building infrastructure, technology base). The main policy measures in this area include:

— Increasing the number of foreign entities in host countries for their better development by introducing mandatory measures:

  - Increase of export volumes
  - Increase of skills
  - Imports of technology

— Increasing the number of foreign entities in host countries for their better development by stimulating certain desired activities such as:

  - Providing technology to domestic companies
  - Creation of capacities in the host country for R & D

Despite the positive attitude towards FDI there are still concerns about their potential negative impacts. These concerns can be summarized as follows (OECD, *1999*, p. 3-93):

— Anticompetitive practices of establishments of foreign entities
— Risk investments and capital losses threatening the balance of payments of countries
— Tax evasion and irregular internal factory pricing between the operations of foreign entities to avoid taxation in the host country
— Export of technology and activities polluting the environment
— Squeezing out native enterprises from the market and suppression of the domestic business development
— Circumvention of local products, technologies and structures, and ignoring the local business culture with negative socio-cultural impacts
— Legislative reliefs to multinational companies in labour and environmental areas, especially in different export-oriented zones

— Disproportionate impact on the economy and on decisions of state authorities related to strategic issues, which could have potentially negative effects on the country's economic development and national security

From the historical information in this thesis's subchapter it is evident that the nature of government policy towards FDI is mainly focused on increasing the positive impact of FDI on the economy of the host country and the elimination of potential concerns about using a wide range of policies and measures.

2.3 The legislative rules regulating the FDI

This part of the work conveys information about the new law on investment aids, which took effect on 1st January 2008 and its amendment on 1.4.2009, which provides conditions for granting investment aid, its forms, procedures and the competence of government in providing aid and about the control of its use.

On the 1st January 2008, the new law no.561/2007 L.C. about investment aid and amendment of certain acts (in text referred as "Investment aid act" or the "Act") came into force. Short after on 1.4.2009 softened measures were set up with the restatement of the Law on February 17th, 2009 (Act 56/2009 L.C.), which changed and amended the Act no. 561/2007 L.C. about investment (Law Collection no. 56/2009, page 774, part 27).

This was another step by the cabinet to respond to the impacts of financial crisis and the decrease in the investment inflow. The point of this amendment was that the state aid should also be eligible for smaller projects. The amount of investment support was associated with the unemployment rate in the respective districts. This adjustment followed the Brussels' regulations from the 1/1/2009, which said that those regions of the Union whose GDP exceeded the average EU GDP (in Slovakia this applied to the Bratislava region) has no right to receive any other subventions, but other areas still can have generous subventions. Among other things, the proportion that the applicant needed to put into the project himself was reduced.

§ 1 of this Act describes the point of the amendment as follows (Law Collection no. 561/2007, page 4150, part 235):

(1) This Act regulates the conditions for granting an investment aid for regional development, the scope of public authorities in providing investment support and control of its use.
(2) This Act is a scheme of state aid under the Special Act

The Act on investment Aid modifies the conditions for granting investment aids for regional development, investment aid forms, procedures and competence of government with emphasis on the emancipation of domestic and foreign investors and transparency of these investment aids in Slovakia.
This investment aid act, which was approved by the government, improved the previous law on investment incentives. This law equalizes domestic and foreign investors (Press conference after the government negotiations on 15th August 2007):

"The new law do not mentions foreign investors, but only investors"

Lubomir Jahnatek, 2007

For a better understanding of the law, I will define the concept of investment aid in terms of the Act:
Investment aid is an aid to support the initial investment and job creation, and this can be provided in several ways according to Jan Carnogursky-ULC PRO BONO (2008):

1. Grants for acquisition of tangible and intangible assets (the provider of this investment aid form is the Ministry of Economy
2. The reductions in income tax (the provider of this investment aid form is the Ministry of Finance)
3. Contributions for created new jobs (provider of this investment aid form is the Ministry of Labour, Social Affairs and Family through the Headquarter of Labour, Social Affairs and Family)
4. Transfer or substitution of immovable property at a lower price than the market value of the property (the provider of this investment aid form is the owner or

property manager or the Slovak Land Fund or it may be a village, higher territorial unit or an organization)

Conditions and limits for providing various forms of investment aids are differentiated by law:

- According to industry and region:
  - Manufacturing region
  - Tourism
  - technology centers (i.e. places where the recipient of investment aid carries out activities that improve or change products, production processes and technologies)
  - Centers of Strategic Services (places where the recipient provides services with high added value, support employment of qualified experts)

The applicants for investment aid must submit the investment project in two documentary copies and also in an electronic form to the Ministry of Economy. The Ministry will assess the investment plan and if it includes the necessary information it will develop and provide an expert´s report within 30 days. If the assessment shows that the applicant is likely to qualify for investment aid, the Ministry will work out a proposal, where the proposed forms of investment aid, and the amount and conditions of grant will be outlined. This proposal will be sent to the investment aid provider, who will give a written statement within 30 days to the Ministry as to whether they agree or disagree with the investment support. The Ministry will acknowledge that the investment project is or is not eligible on the basis of the written statement and it will provide an investment aid offer within 30 days (Law collection no. 145/2008).

Within 60 days of delivering the offer, the applicant may submit an application to the Ministry of Economy for investment aid with relevant annexes with respect to the investment aid act. On the basis of these applications the Ministry submits a proposal for approval of an investment aid to the government of SR. If the government approves this proposal the Ministry provides within 15 days from the approval a decision about the approval of the investment aid to the applicant and delivers it to the provider of investment aid.

In some cases, the Ministry has to notify the European Committee about an investment aid and the approval depends then on the Commission´s decision whether the proposed investment aid is compatible with the EU common market.

The Recipient of the investment aid has to (Law collection no. 145/2008):

- *Preserve* tangible and intangible assets which were granted by the investment aid in proportion to the actual amount of the received aid and in specified investment structure specified in time of the aid application, but at least five tax years after the tax period in which the investment project ended.
- *maintain* the number of new jobs created and the occupations of these positions by employees on whose the investment aid will be taken, at least five years from the date of the first occupation of the position
- *qualify for the requirements* of the investment aid within three calendar years from the approval of the investment aid,
- *fill the jobs*, which were directly created by the initial investment within three years after the end of the investment plan
- *implement the investment project* so that at least 25% of eligible costs must be financed from his own resources or through external financing,
- *return the excess* on the authorized amount, including penalties in case of an investment aid above the authorized amount.

Cancellation and suspension of investment grants is possible on request of the beneficiary if the investment aid has not been used already (Law collection no. 145/2008).

If the beneficiary:

- did not start within 24 months after the approval of an investment aid to acquire tangible and intangible assets or
- did not start within three years after the approval of an investment aid to pursue a business activity referred in the investment objective or
- did not comply with any of the conditions for an investment aid,

than the decision approval of an investment aid granted expires and the investment aid has to be refunded.

Investment aid for the next investment project for the *same beneficiary* is only possible *if* the implementation of the investment project has been already completed, where a state aid was approved and this approved aid was exhausted.

An investment aid cannot be approved for the same beneficiary whom the state aid was approved by law and this aid was not exhausted yet.

Regional map of the state aid in the Slovak Republic for the years 2007 - 2013

A regional aid map defines the regions of a Member State eligible for national regional investment aid for large enterprises under EC Treaty state aid rules and establishes the maximum permitted levels of such aid in the eligible regions (Europa, Press releases RAPID, 2010). The whole territory of the Slovak Republic was eligible for the period 1.5.2004-31.12.2006 under the derogation of either Article 87 (3) (a) or Article 87 (3) (c) of the EC Treaty. For the period 1.1.2007-31.12.2013 three of four Slovak NUTS-II regions continued to be eligible to receive regional investment aid under the derogation of Article 87 (3) (a) of the EC Treaty. Certain parts of the NUTS-II region of SK01 Bratislavský kraj remained eligible under the derogation of Article 87 (3) (c) of the EC Treaty as transitional additional coverage for the period 1.1.2007-31.12.2008 (European commission, 2006, p.2), which was amended by the EU guidelines, so the Bratislava region will not receive further investment aids.

The proposed limits below are related to large enterprises. In the case of medium-sized enterprises this ceiling can be risen up to 10 percentage points and for small enterprises by 20 percentage points.

Table 4 *SLOVAK REPUBLIC - National regional state aid map 1.1.2007-31.12.2013*

(NUTS II REGION) *(NUTS III REGION)*	**Ceiling for regional investment aid[1] (Applicable to large enterprises)**
1. Regions eligible for aid under Article 87(3) (a) of the EC Treaty for the period 1.1.2007- 31.12.2013	
SK02 Západné Slovensko	40%
SK03 Stredné Slovensko	50%
SK04 Východné Slovensko	50%
2. Regions eligible for transitional coverage under Article 87(3) (c) of the EC Treaty for the period 1.1.2007-31.12.2008	
SK01 Bratislavský kraj	
LAU1-102 Okres Bratislava II	10%
LAU1-103 Okres Bratislava III	10%
LAU1-104 Okres Bratislava IV	10%
LAU2-529435 Bratislava-mestská časť Čunovo	10%
LAU2-529443 Bratislava-mestská časť Jarovce	10%
LAU2-529494 Bratislava-mestská časť Rusovce	10%
LAU1 – 106 Okres Malacky	10%
LAU1 – 108 Okres Senec	10%

Source: European commission, *State aid N 469/06 – Slovak Republic Regional aid map 2007-2013,* 13.12.2006

It is also important to know where all the legal framework adjustments should be heading. It is necessary to adjust the scope of work towards a more transparent, stable, predictable environment for foreign investors, which would provide investment security and of course, increase the attractiveness of investing in Slovakia. A good legislative framework is not the only factor that attracts foreign investors but there is no doubt that an introduction of better legislative could facilitate a successful entry of FDI and also enable the subsequent activity of foreign investors.

2.4 The main advantages provided by the Slovak Republic and it´s investment climate

Why invest in Slovakia? This is one the main questions which would be certainly asked by foreign investors, who would want to invest in Slovakia. The answer surely is not easy and

to be able to answer this question much data on information needs to be considered. Therefore the most essential advantages of the Slovak Republic, as host country for foreign investors, are listed below (SARIO, *2010*):

- Central European hub and favorable geographic location
- Political & economic stability,
- 19% flat tax rate and 0% dividend tax
- Availability of highly skilled workforce
- Low labour costs vs. high labour productivity
- Euro as the official currency
- Large selection of industrial land and offices available for purchase/lease
- Harmonized investment incentives
- Infrastructure that is growing steadily
- High innovation potential for R&D projects

Host countries often do not offer very attractive conditions to investors' especially if the host country does not have sufficient market size, rate of economic growth, skilled manpower, good infrastructure, information on investment opportunities and if they release vague statements about the investment conditions of the host country.

The most important criteria for a country´s assessment by foreign investors are (OECD, *2003*, p.1-39):

- The economy´s performance - economic growth, monetary stability, development of the current account deficit, public finance and the unemployment rate are taken into account
- Political risk - refers to the complications which an investor may face as a result of political decisions that alter the expected outcome and value of a given economic action.
- Debt burden - assessment of the country with regard to long-service export, current account balance to GDP and foreign debt to GDP. Restructuring of foreign debt of the country is also taken into account

— Access to international financial markets- reflects the immediate access of the country to international capital markets
— Credit rating - the direct ratings of the country by Moody's, Standard & Poor's IBCA etc.

A prospective investor could conclude that the environment as assessed by the above criteria, and despite its liberalization, is too unpredictable or too risky or lacks certain important elements.

As for Slovakia the **position** in the heart of Europe is really a huge advantage, because with a radius of 1000 km an investor can reach 350 million potential customers.

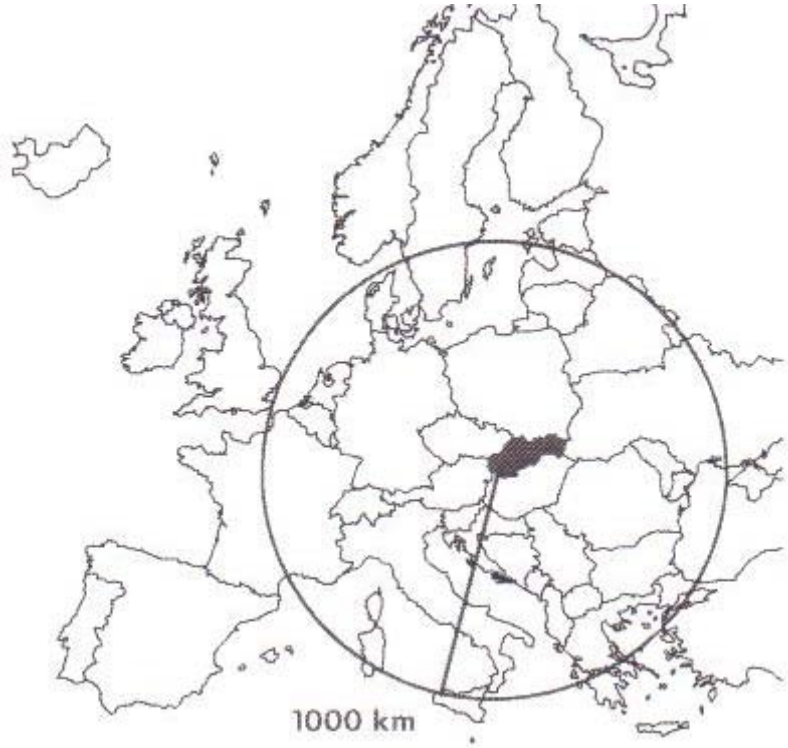


Figure 3 *Position of Slovakia in Europe*
Source: SARIO, Why invest in Slovakia 2010

Political stability is one of the most important factors, which are invariably required to encourage the investor take part in discussions with the host country about investing.

Slovakia has enjoyed political stability in the short and long term thus far and was evaluated and presented in past years as positive, despite the current ongoing economic

crisis, which moves the political spectrum in the neighboring countries of the Slovak Republic. The political direction is founded on democratic principles and parliamentary democracy, which is acknowledged by political parties, throughout Europe. A proof of these principles is the acceptance of the Slovak Republic into European structures, where they have to be inevitably shared in the euro-area.

Business Monitor International notes that while the ruling parties in the coalition have had a fairly stable relationship since 2006 and Slovakia was a very attractive country for investors in the long term view, there have been notable incidents of further regression regarding public sector corruption in recent months, and according to Transparency International's 2009 survey data, half of Slovakians perceive the justice system and the courts as corrupt. Furthermore, BMI acknowledges that there is corruption, which has deteriorated under the current government's leadership since 2006 and it is likely to weigh on Slovakia's political risk profile going forward, and will serve as a barrier to foreign investment. Currently, in 2010 the rating of political Risk in Slovakia is 75.2 out of 100 worsened compared to year 2009 where the risk was 81,5 and the year before the risk was 83.1 (Business Monitor Online, *2010*).

Economic stability goes hand in hand with the political stability and was also positive in the past years. Slovakia has successfully implemented most of the planned structural reforms. Today, Slovakia is widely seen as a success model for other EU countries for creating an investment and business-friendly environment. Slovakia is a full member of the EU, NATO, OECD, Euro and Schengen Area, which serves as a guaranty of economic stability for foreign investors. Slovakia is generally recognized as an open market economy, which is able and willing to pay its liabilities. Based on Standard and Poor's ratings, Slovakia has become the leader of the Central European region (see table 3). However nowadays the whole Eastern Europe area faces difficult times, especially Greece, which will have negative impacts on the whole of the EU, including Slovakia.

Table 5 *Credit ratings for the countries of V4*

Country	Standard and Poor's	Moody's	Fitch	OECD Country Risk *(the lower the better)*
Slovakia	A+ stable outlook	A1 stable outlook	A+ stable outlook	0
Czech Republic	A stable outlook	A1 stable outlook	A+ stable outlook	0
Poland	A- stable outlook	A2 stable outlook	A- stable outlook	2
Hungary	BBB- stable outlook	Baa1 negative outlook	BBB negative outlook	0

Source: Standard & Poor's, www.standardandpoors.com, April 2010; Moody's, www.moodys.com, April 2010; Fitch, www.fitchratings.com, April 2010; OECD Country Risk Report as of 29 January, 2010, www.oecd.org, 2010

The **tax system** plays also an important role for a foreign investor. What foreign investors need is a simple and transparent tax system. The tax system in Slovakia is considered to be very simple, neutral and effective, because all the types and amounts of income are taxed at a flat rate of 19% and there is no double taxation and no dividend tax. Medicaments and books form one exception from the flat tax rate and have a reduced tax rate of 10%.

Educated work force also influences the decisions of foreign investors. Slovakia has a strong tradition in terms of educated specialists and reaches one of the highest proportion of workforce with a secondary, higher, education and university education among all the European countries. Furthermore, the percentage of people with a university education is on the rise. The overall number of university students is 211 553. The most preferred universities are situated in Bratislava, Košice, Žilina, Zvolen, Trnava and Trenčín. The workforce of more than 2.1 million has a strong tradition in engineering and mechanical production. Foreign companies frequently praise the motivation and abilities of Slovakia's workers who also possess good language and computer skills (SARIO, *2010*).

The average monthly wages are still low compared to the Western Europe and are still lower than the wages in Poland, Hungary and Czech Republic. Social security contributions in Slovakia cover all the contributions in which there are no extra or hidden costs for the employer. The employer has to pay the social security costs for his employee of 35.2% on top of his salary. The employee pays for himself the social security costs of 13.4%. The contributions in Slovakia are upwardly limited. Everything earned above this figure is not subject to social security payments (SARIO, *2010*). These are also a factors, which could make an investor´s decision to invest in Slovakia much easier.

Data on wages can be traced to the Figure no. 3 and it informs us about the average salary in Slovakia during the past and also forecast years (the average real wage growth in Slovakia for the years of the economic crisis, will certainly be lower. It is also worth to mention that there are significant regional and sector differences in terms of wages within Slovakia.

Figure 4 *Past, current and forecasted average wages in Slovakia*
Source: www.statistics.sk

In figure no. 4 we can observe the difference in the average wages compared to the neighboring countries, but the gap is not too wide. However, from the view of the investor Slovakia remains in the lead.

Table 6 *Average monthly wage and labour costs in EUR within the V4 countries in 2009*

	Slovakia	Czech Republic	Poland	Hungary
Average monthly wage (in €)	744.50	900	856	782
Social Security paid by employer	35.2%	26%	14.93%–18.16%	29%
Monthly total labour costs (in €)	1,007	1,134	983 – 1,011	1,009

Source: Statistical offices of Slovakia, Czech Republic, Poland, Hungary

2.5 Problems associated with the inflow of FDI in Slovakia

Despite to all the positives that are stated in previous sections, this section describes selected problems of FDI especially in the context of the economic crisis, which currently affects the foreign investment in Slovakia, but also the global economy. The economic crisis has global effects and scales over a wide range of sectors. The world economy is probably in the worst crisis for the last sixty years. To be able to understand the problems which are associated with the inflow of foreign investment, it is necessary to bring this issue in the context of the development of foreign investment in the European region, which are also problems of Slovak Republic and therefore they cannot be avoided.

Economies in Central and Eastern Europe grew strongly in the 2000's, fueled by cheap credit from Western banks that saw the region as a superb investment opportunity. Newly-found political stability and high levels of economic growth made investing there seem like an obvious choice. Vast sums of money flowed in, fueling a property boom based on easy credit. When the banks pulled out, parts of the region were left high and dry (PricewaterhouseCoopers, 2010) New report by PWC (PricewaterhouseCoopers) suggests there will be a gradual recovery in foreign direct investment in CEE by 2013. The central and Eastern Europe (CEE) region experienced a five-fold increase in foreign direct investment (FDI) inflows between 2003 and 2008, rising from €24.9 billion to €128.5 billion. Russia was the destination which attracted much of this additional investment as its inflows rose from less than €6.6 billion in 2003 to more than €58 billion in 2008. PWC estimates that FDI to CEE declined from €128.5 billion in 2008 to €63.85 billion in 2009. Looking ahead, FDI is projected to recover only modestly from 2010 onwards and could reach around €142.6 billion by 2014.

Furthermore *Slovakia loses* its *creditability* and has a worse rating outlook compared to the past years. Moody's Investor's Service international rating agency changed the rating outlook commitments of Slovakia, for instance A1 to stable from positive. As the vice president of Moody's Investor's Service said, although the credit reliability of Slovakia benefited from structural improvements in recent years the *decreased rating reflects the belief of the Agency that the risk model of growth based on investments and exports widened during the current crisis*.

Representatives of Volkswagen stated that the *qualification structure* of the new generation in recent years *does not develop favorably*, because of the autonomy that has been granted to colleges. This brought an *excessive number of courses*. Compared with the Czech Republic there are about 100% more.

In the area of *R&D* there was a fairly *significant reduction of grants* with the entrance of foreign investors. This problem arises in the host country mainly because the large conglomerates focus their research in parent organizations. This phenomenon can be seen as global.

Representatives of many organizations mention also the problem with *continuing bureaucracy and corruption* (Hoskova, 2001, p. 44).

3. Developments and trends of foreign investment in Slovakia from 2000 to 2009

This section aims to show more detailed results and the tendencies of foreign direct investments in Slovakia from 2000 to 2009, their importance on the Slovak economy and their impact on key macroeconomic indicators. Foreign direct investments are affected by several factors such as the public finance, budget and balance of payments. Conclusions are largely based on the data of the National Bank of Slovakia, the Ministry of Economy and the statistical Office of the Slovak Republic until 2009 and on forecasts for further development of foreign direct investment in Slovakia. The impact of the global economic crisis on foreign direct investment in Slovakia will be also considered.

Table 7 *Change of FDI in the calendar year*

Year	Cumulative FDI (in mil. €)	Change of FDI (in mil. €)
1999	3 213	-
2000	5 129	1 916
2001	6 495	1 366
2002	8 563	2 068
2003	12 617	4 054
2004	16 068	3 451
2005	19 968	3 900
2006	25 517	5 549
2007	29 058	3 541
2008	32 606	3 548
2009	34 225	1 619

Source: Data used from: www.statistics.sk , 2010 (own Table)

3.1 FDI inflows in the years 2000-2009 in context of structural changes in the Slovak economy

The key forms of foreign capital inflow into our economy are foreign direct investments (FDI) and this section will describe its specific development in numbers since 1999 with regard to structural change of the economy in Slovakia.

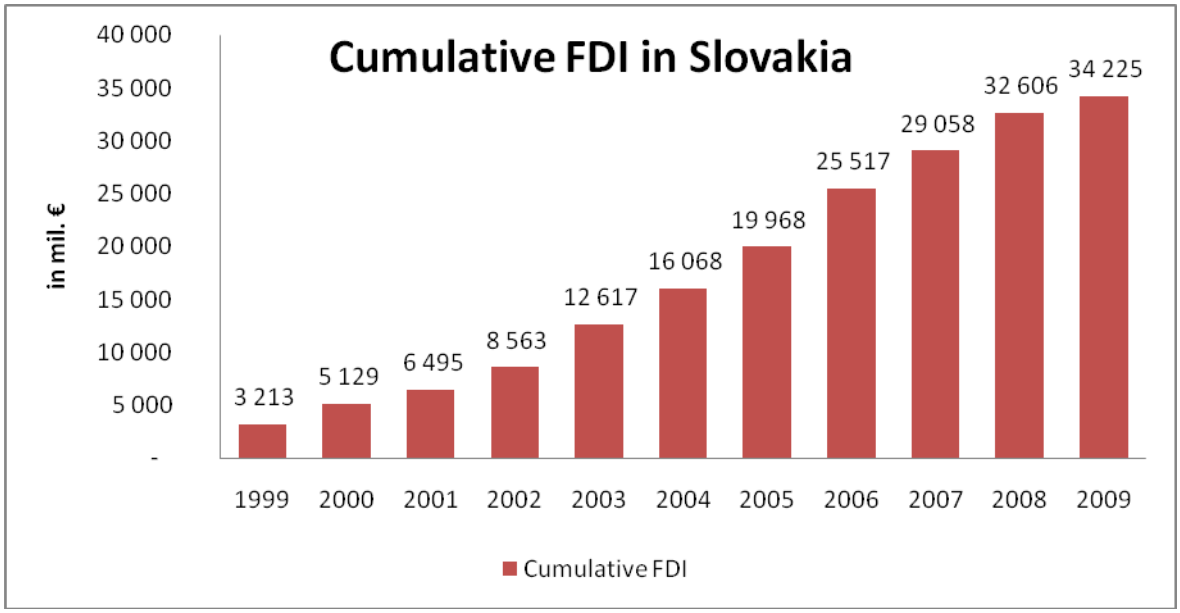


Figure 5 *Development of FDI in year 1999 – 2009 in mil. EUR*

Source: The national Bank of Slovakia; The Statistical Yearbook of Slovak Republic, own Table

Based on the results from the *year 2000*, foreign direct investment had a *growing trend* but the volume and the dynamics lagged behind the needs of Slovakian economy and the surrounding countries.

In year 2000 the inflow of foreign direct investment (FDI) rose to €5.1 billion and started to gain on momentum. Slovakia formed a privatization policy, which was opened to foreign investors and promoted the industrial potential. The year 2000 represents a significant increase by about €2 billion of FDI into Slovakia. This amount for the whole year 2000 is almost 2/3 of the cumulative amount of foreign direct investment in Slovak republic at the end of 1999. This trend also continued in the future.

In 2001, Slovakia received additional €1.3 billion and in *2002* FDI inflows reached €8.6 billion.

At the end of *year 2003* the value of FDI in Slovakia was €12.6 billion compared with €6.5 billion at the end of 2001 from which €0.6 billion were invested in the industrial sector, €0.09 billion in finance and €0.34 billion in government and defense and also in compulsory social security.

In *December 2004* the status of FDI rose to €16.0 billion. An amount of €13.3 billion went into business and €2.7 billion in the banking sector.
In *December 2005* FDI reached €19.9 billion. In this year the inflow of FDI rose by €3.9 billion.
In year 2006, FDI inflows continued to increase. Foreign direct investments increased by €5.5 billion, which was in terms of FDI inflows the strongest year since 2002. While in year 2005 more than 60% of FDI were accounted from the reinvested earnings, in 2006 the value of 70% of FDI were acquired from equity capital i.e. new deposits of foreign investors.
In 2007 there was again an increase of FDI to €29.0 billion. Foreign direct investment increased by €0.34 billion in the bank sector and by €0.67 billion in the corporate sector.

In 2008, the activity of investors stabilized as a result of the global financial crises, the increase in cost of capital and the decrease in economical growth dynamics threw the world.

In 2009, foreign direct investments decreased by more than 50% compared to FDI inflows in 2008 due to the impact of global financial crises from year 2008. The cost of capital remained a high level as well, which caused a negative trend in the dynamics of economical growth. The only positive event was the real estate investment by TriGranit. This single investment accounted for more than 40% of total Slovakian FDI inflows in 2009 (PricewatehouseCoopers, *2010*).

Table 8 FDI *Structure with regard to the industry*

	2000	2001	2002	**2003**	**2004**	**2005**	**2006**	**2007**
	in mil. €	in mil. €	in mil. €	in mil. €	in mil. €	in mil. €	in mil. €	in mil. €
Agriculture, hunting and forestry	5,4	19,0	24,8	36,6	62,2	59,5	55,0	90,0
Mining and quarrying	54,5	78,7	75,6	72,7	91,4	103,7	342,0	300,0
Manufacturing	**2 720,4**	**2 832,2**	**3 137,6**	**4 811,5**	**6 981,8**	**9 592,8**	**10 972,0**	**11 314,0**
Electricity, gas and water supply	**12,6**	**14,4**	**1 046,8**	**1 172,9**	**1 333,3**	**1 378,7**	**3 538,0**	**4 045,0**
Construction	61,5	51,4	65,2	104,9	174,2	225,3	309,0	333,0
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	594,2	688,3	912,0	1 843,1	2 203,8	2 354,2	3 013,0	3 526,0
Hotels and restaurants	39,0	44,6	50,4	71,7	38,4	46,4	33,0	60,0
Transport, storage and communication	863,1	875,7	939,4	929,0	995,4	1 215,6	1 524,0	1 502,0
Financial intermediation	**611,4**	**1 646,8**	**1 964,0**	**2 843,3**	**3 223,9**	**3 657,2**	**4 077,0**	**5 125,0**
Real estate, renting and business activities	150,3	211,5	309,6	626,7	871,8	1 218,1	1 521,0	2 585,0
Other community, social and personal service activities	16,9	32,4	38,4	104,6	91,8	116,4	135,0	179,0
Total	**5 129**	**6 495**	**8 564**	**12 617**	**16 068**	**19 968**	**25 517**	**29 058**

Source: National Bank of Slovakia, The impact of foreign direct investments on Slovakian economy, own table

The following section will analyze the FDI inflow development in years 2000- 2009 and the impact of FDI on the structure of Slovakian economy.

FDI inflows in 2000 had an upward trend throughout most sectors in Slovak Republic. The biggest growth occurred in the transport, storage, manufacturing and communication sector. In this year Deutsche Telekom acquired (DT) a 51% stake in Slovak Telecom for €0.9 billion. Later Orange, a subsidiary of France Telecom, bought a second license to provide mobile service and went ahead of DT.

FDI inflows in 2001 were a reflection of year 2000, where foreign investors positively evaluated Slovakia in terms of potential investments. It was a year of financial operations, particularly in the *financial intermediation* sector, where growth was evident compared to investments in year 2000 which totaled €0.6 billion and investments in year 2001 which totaled €1.6 billion. It was a €1 billion increase in investments in this sector. Previous acquisitions from year 2000 were then followed by further acquisitions of the Slovakian branch of CSOB Bank by Belgian KBC Bank for €0.4 billion and of Poľnobanka Bank by Italy's UniCredito for €0.03 billion euro. This acquisitions´ purpose was to strengthen the Slovak bank sector by allowing European banks to participate in Slovakia. These actions were accompanied by consolidation and improvements in the bank sector and became one of the success stories of the first Government of M. Dzurinda. Year 2001 was also the year where the most important Slovak insurer, the Slovak Insurance was sold to the German group Allianz.

FDI inflows in 2002. The above mentioned foreign direct investments were revitalized thanks to an end of several privatizations in the energy sector. The highlight of this year was the purchase of the Slovak Gas Industry (SPP), the only gas company in the country, by Gaz de France and Ruhrgas, each with 24.5% of the shares, where the Slovak Republic retained the remaining 51%. Gaz de France has become the largest French investors in Slovakia (investments worth around €1.4 billion). With regard to the electricity distribution network which was divided between three companies (ZSE- Western-Slovakian electricity, SSE-Mid-Slovakian electricity and VSE-Eastern-Slovakian electricity), EdF acquired one of them (SSE), which also was a major investment (more than €0.16 billion). In this year government also approved the privatization of SE (Slovak Electricity) by selling 66% of total capital shares owned by the NPF (National Land Fund) to a strategic investor. ENEL SpA offered the highest cash price for this 66% stake of SE (€0.84 billion) and with this acquired the majority in SE (KOLLÁR, 2002. p. 976). The year 2002 was characterized by a spirit of energy, where foreign investors brought the necessary capital for further development in the Slovakian economy.

FDI inflows in the year 2003 - 2004. With the sale of a majority stake in the Slovakian refinery (Slovnaft) to the Hungarian company MOL, the petroleum industry became one of

the top ranked industries in terms of FDI in Slovakia. The statistics of FDI inflows since 2003 includes the government sector, which essentially reflects the privatization transactions. Its share of 18.2% of total FDI inflow in the period of January 2003 - June 2004 primarily represents the sales of three power distribution companies (Geffert, 2005, p. 3-25). One of the sectors which offer another investment potential is the automobile sector together with its component suppliers and manufacturers. The decision of PSA (Pequeot Citröen - January 2003) to settle a factory in Trnava and the plan of VAG VW to increase the capacity of the factory in Bratislava (the construction of off-road vehicles), followed by Kia Motors and Hyundai Mobis (2005)to invest in Žilina brought a new dynamic in the development of FDI in Slovakia. It should also be noted that the direct investment of Peugeot reached around €0.7 billion and was therefore, in terms of investment volume, far behind Gaz de France and France Télécom. However, this decision was the reason for the arrival of a few hundred smaller investments related to this sub-sector. Naturally, the automobile sector is certainly not the only major sector. It is worth mentioning that there are also other major investors besides the already mentioned French investors such as the U.S. Steel Kosice (metallurgy and steel), Whirlpool in Poprad (electrical appliances), John Mansfield in Trnava (optical fibers), Samsung Electronics (television screens and components) Beckaert (bars and wires), Tesco (organized distribution), etc. Despite this fact the automobile industry became an integral part of the Slovak economy since 2003 (54,700 employees, 25.4% of total industrial production, turnover of €6.88 billion, 25% of global exports, i.e. €5.62 billion).

Currently, three multinational automobile companies and an extensive network of subcontractors are operating in Slovakia:

- *Volkswagen Slovakia Ltd.*
- *PSA Peugeot Citroën*
- *Hyundai-Kia*

Therefore the years 2003 and 2004 are years where many automobile companies established their factories in Slovakia and brought many firsts e.g. Slovakia became predominant in the number of cars produced per head of the population. With this,

Slovakia started to depend on the automobile industry, which brought many positives and negatives for Slovakia.

The year 2005 brought in terms of FDI and its impact on the sectoral structure only minimum changes, but several already established foreign investors announced plans to further expand their investment projects. The Carmaker PSA Peugeot Citroen officially announced on 8th December the decision to build the next major plant in Trnava. The new plant with an investment of €0.35 billion had a production capacity of 150,000 cars and created 1,800 new jobs. Another significant investment was a project of Visteon, one of the largest manufacturers of automobile components, which opened in Nitra in May 2005 to build a factory to produce air conditioning and interior components with an investment of €0.04 billion.

In year 2006 FDI rose again. The most significant transaction was the inflow of funds from the privatization of 66% stake in Slovak power plants (€0.89 billion) from the Italian ENEL in April 2006. The largest announced project became the project of SONY worth of €0.07 billion to build a LCD TV factory in Nitra in year 2007 (KOLLÁR, 2006. p. 432).

In 2007 foreign investments boosted the Slovakian economy. Slovakia achieved a record growth of 10.3%. This dynamic growth was influenced by the massive foreign investment inflows, where investments exceeded €1.2 billion. One-quarter of the gross domestic product (GDP) in Slovakia was created by the automobile industry and at the same time contributed with a third of total exports of Slovakia. This period was a period of great success and investment plans for the future. The biggest investors were Austria, Cyprus, Czech Republic, Netherlands, South Korea, Germany and France.
In terms of industry the most foreign investments went to financial intermediation, real estate, renting and business activities, manufacturing, wholesale trade, retail trade, repair of motor vehicles, motorcycles and household goods.

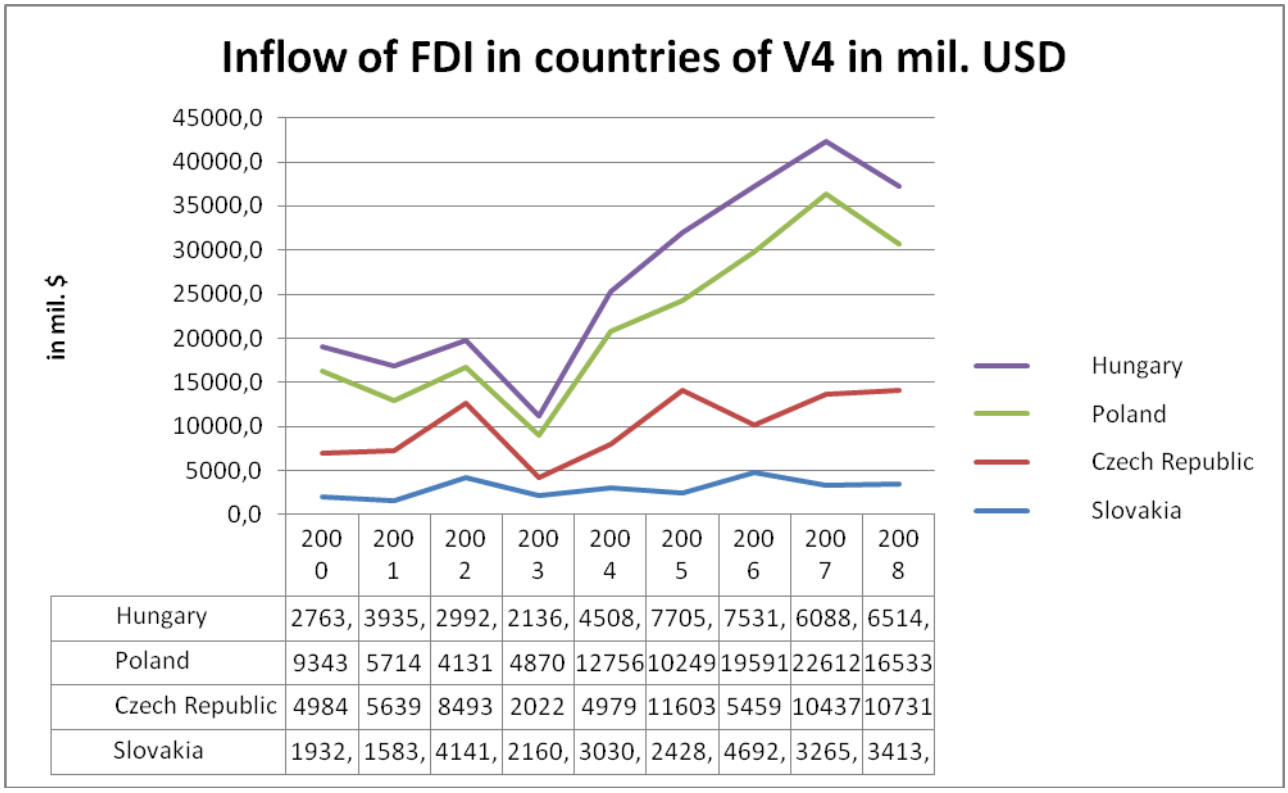
In 2008 there was a stagnation of FDI which is also visible in figure 5. SARIO only realized foreign investment projects for €0.5 billion and this resulted to the fall of investments by three fifths compared to year 2007. Most of these projects (65 %) were successfully finished before the global economic crisis, that is, especially in the first half of

2008. This statistics also contains the most important €0.3 billion investment of the carmaker Volkswagen. Without this investment project only €0.23 billion would be invested in Slovakia. Year 2008 created a big gap in terms of FDI inflows compared to years 2007 or 2006.

The Industrial production fell by 16.8% in Slovakia because of the negative impact of the global economic crisis in December 2008. Almost all industries declined, but the greatest decrease happened to be in the car industry, one of the driving forces of the economy in Slovakia.

Electrical Engineering also fell by 12.2 % while it showed a slight 2.6% increase in November 2008. The only industry that showed growth was the leather processing industry.

Developments *in year 2009* were negative. Industrial production in January was also influenced by the gas crisis, during which several large companies had to limit or stop the production. Production of cars decreased to 35.7 % a year because the sales were affected by the crisis. Volkswagen, PSA Peugeot Citroën and KIA continued to decrease the production or started to work on short procedures; several companies canceled their operations and announced layoffs. Overall industrial production (excluding mining, manufacturing and distribution of energy) decreased by 18.8 percent. Slovakia came last amongst the V4 countries in terms of volume of FDI inflows which is indicated in the figure 6.



	2000	2001	2002	2003	2004	2005	2006	2007	2008
Hungary	2763,	3935,	2992,	2136,	4508,	7705,	7531,	6088,	6514,
Poland	9343	5714	4131	4870	12756	10249	19591	22612	16533
Czech Republic	4984	5639	8493	2022	4979	11603	5459	10437	10731
Slovakia	1932,	1583,	4141,	2160,	3030,	2428,	4692,	3265,	3413,

Figure 6 *Inflow of FDI in countries of V4 in mil. USD*

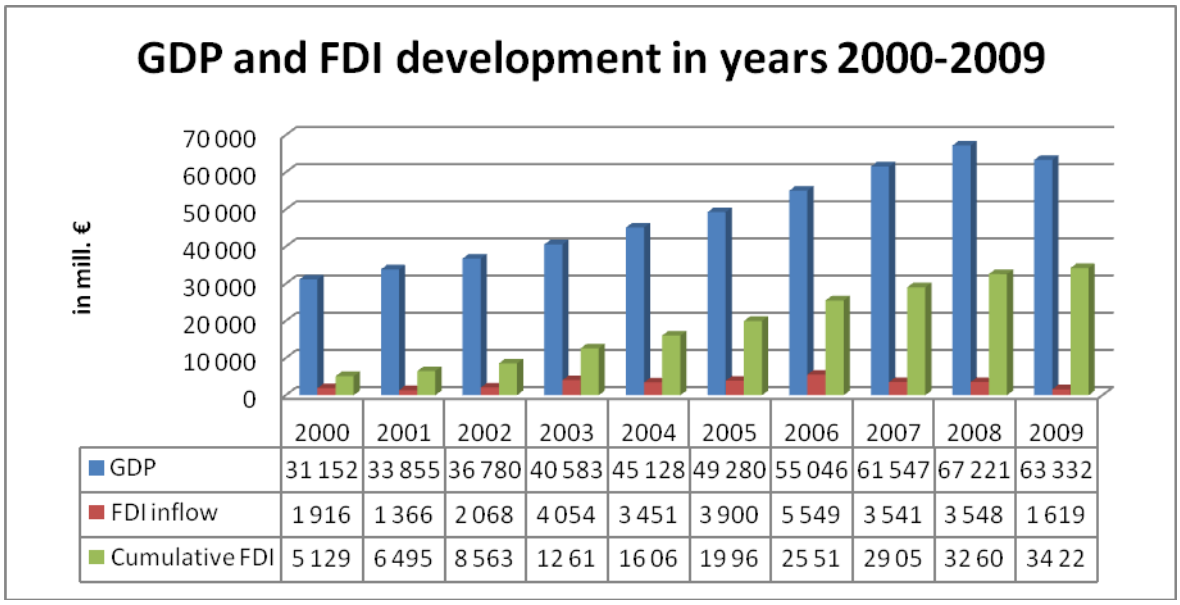
Source: www.unctad.org, own figure

The conclusion from this section is that foreign direct investment in Slovakia will not increase. This statement is also supported by the declaration of the Vienna Institute for International Economic comparison (WIIW), which stated that foreign direct investment (FDI) into Central and Eastern Europe (CCEE) years will decrease in coming years. According to WIIW report the reasons are primarily the global financial crisis, the increase in the cost of investment capital and reduced growth of the European economy.

3.2 Impact of FDI on the Slovak economy

Investments play a significant role in improving the economic performance and its growth potential. The inflow of FDI is affected by several indicators such as GDP, exports, public finance, balance of payments, unemployment, transfer of know-how and technology. The importance of the investment is contingent with its impact on economic performance. The actual amount of investment enhanced by the multiplier effect significantly influences the size of GDP. The interdependence between FDI and GDP is captured by the Figure 7 and

also shows the pace of GDP growth and FDI in Slovakia. The picture clearly indicates the unstable development of FDI that achieved high growth rates and exceeded the growth rates of GDP. This fact proves that despite the volatility of investments (the nature of investment, uncertainty in investment decisions and the effects of various random shocks) their instability is usually not necessarily reflected in the fluctuations of GDP and this is also confirmed in the development of FDI and GDP. Development of GDP in Slovakia had an upward trend until 2008 which is shown in the Figure 8 and was certainly influenced by investments as a component of GDP. In 2008 the development of GDP broke down and investments declined as well due to global economic crisis.



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
GDP	31 152	33 855	36 780	40 583	45 128	49 280	55 046	61 547	67 221	63 332
FDI inflow	1 916	1 366	2 068	4 054	3 451	3 900	5 549	3 541	3 548	1 619
Cumulative FDI	5 129	6 495	8 563	12 61	16 06	19 96	25 51	29 05	32 60	34 22

Figure 7 *GDP and FDI development in years 2000-2009*

Source: www.statistics.sk, own figure

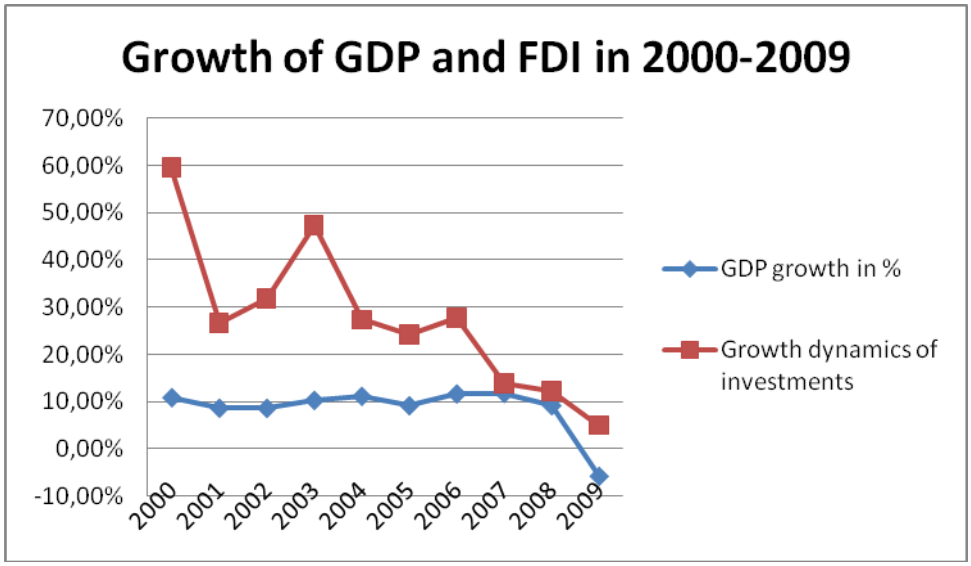


Figure 8 *Growth of GDP and FDI in 2000-2009*

Source: www.statistics.sk, own figure

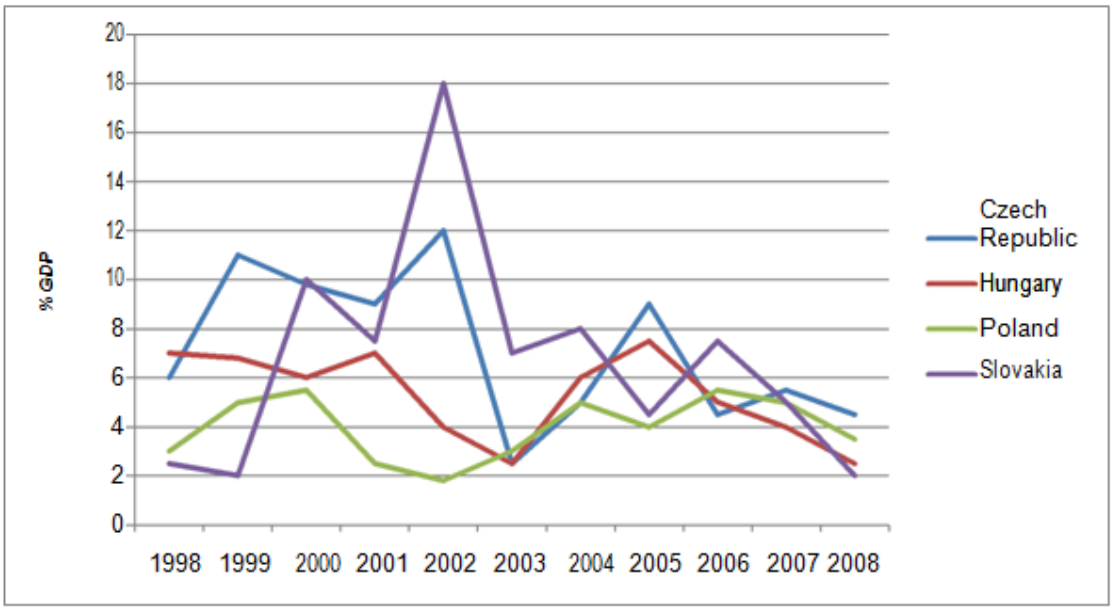


Figure 9 *The Share of FDI on GDP in countries of V4*

Source: http://ekonomika.etrend.sk/ekonomika-slovensko/kam-sa-podeli-investori.html

The positive contribution of foreign direct investment (FDI) to GDP between the V4 countries declined due to the effect of the financial crisis. Figure 9 shows that foreign investments are falling in all countries of V4, but in Slovakia this decrease follows rapidly. In 2002 the contribution of FDI to GDP in Slovakia was the highest amongst the neighboring countries, but in year 2008 it collapsed.

Increased exports are one of the main effects of FDI on domestic industries. Export is carried out either directly or indirectly. In the early years a low growth rate of exports is visible on the figure 10, but since 2002 exports inexorably increased, which can be justified with the following:

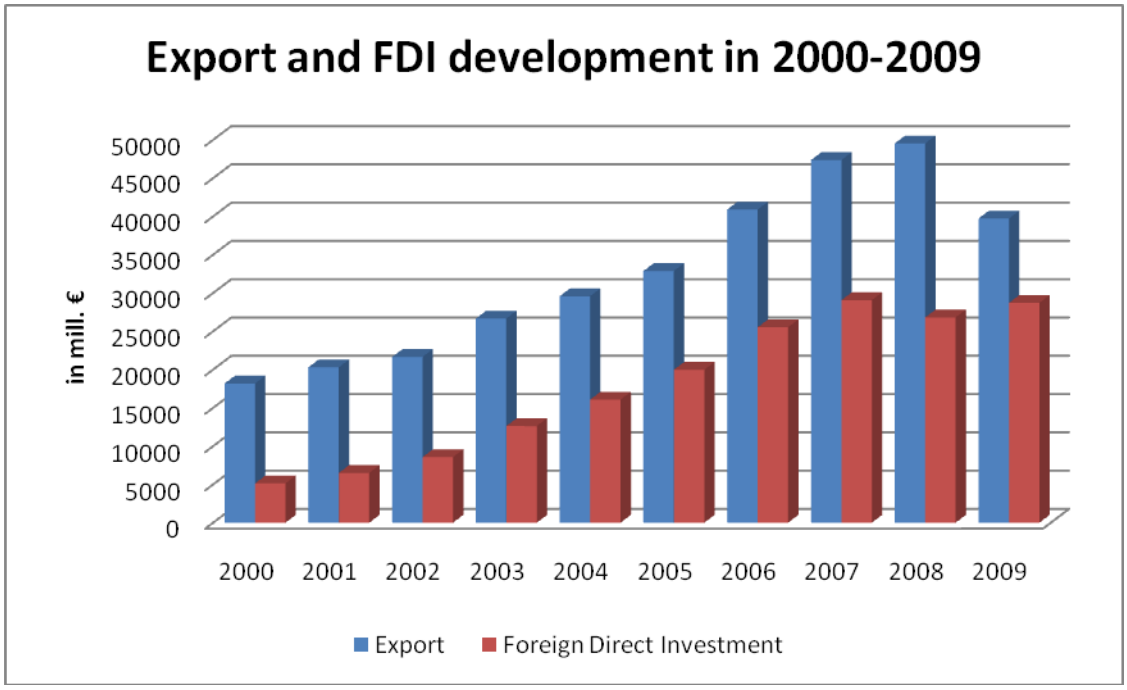


Figure 10 *Export and FDI development in 2000-2009*

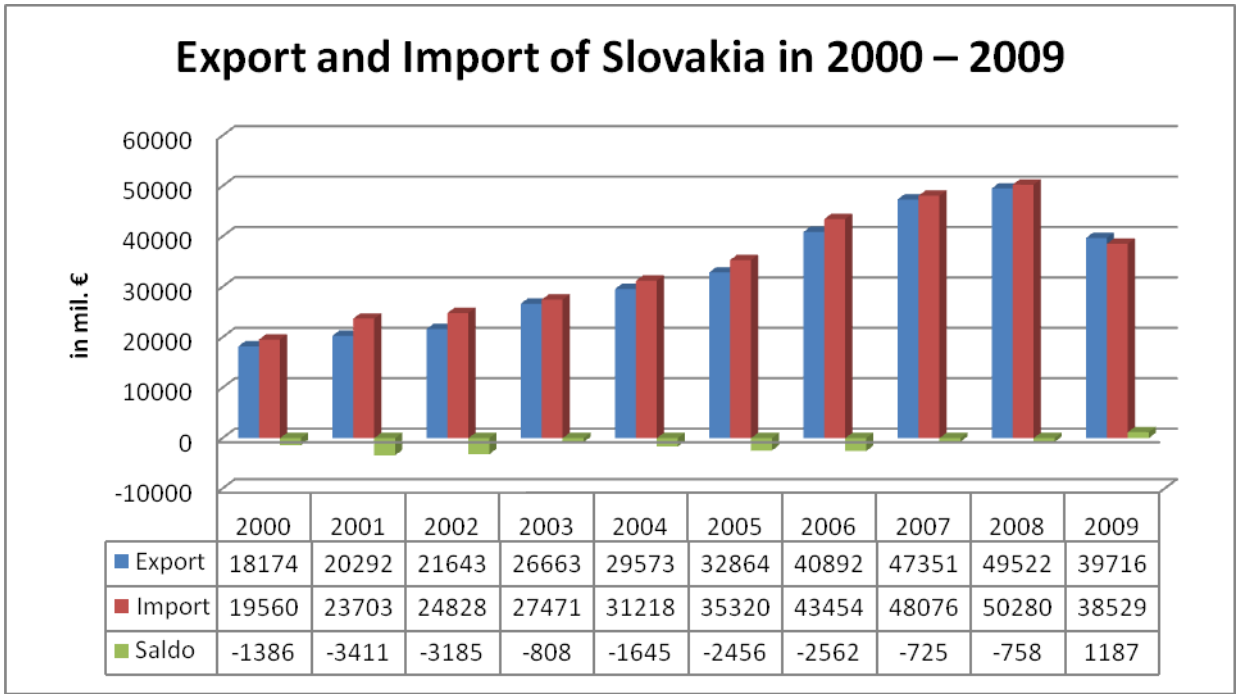
Source: NBS (National Bank of Slovakia), www.nbs.sk, own Figure

Slovakia is a small market and investors who came to Slovakia have been largely export-oriented, which of course resulted in an increase in exports. To put this more simply, an increase of export-orientated investments will lead to increased exports from the host country.

The impact of FDI on the public finances have been largely positive, because new job opportunities were created and resulted in a decrease of unemployment which on the other hand increased the fund inflows from income taxes, corporate income taxes and last but not least VAT from the increased consumption.

The impact of FDI on trade and balance of payments of Slovakia is highly significant primarily because of a small market. The development of exports and imports and the balance in the period from 2000 to 2008 can be easily followed from the figure 11. It is

evident that Slovakia had to fight with a trade deficit in the period from 2000 to 2008, but the predominance of imports over exports did not result from inefficient activities of the well-established foreign companies. In 2009 finally a surplus was achieved thanks to the automobile industry. It is also worth mentioning that exports and imports decreased in 2009 compared to the last three years. Generally only few large companies could influence the results. These are mainly companies from the automobile industry followed by the electrical and telecommunications industries. A clearer picture emerges if we subtract the trade companies from the total volume of exports and imports which would result in the total volume of exports and imports of manufacturing companies that sell their products on world markets and then the conclusion would be that the main objective of an export policy is met.



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Export	18174	20292	21643	26663	29573	32864	40892	47351	49522	39716
Import	19560	23703	24828	27471	31218	35320	43454	48076	50280	38529
Saldo	-1386	-3411	-3185	-808	-1645	-2456	-2562	-725	-758	1187

Figure 11 *Export and Import of Slovakia in 2000 – 2009*

Source: NBS (National Bank of Slovakia) data, www.nbs.sk , own Figure

The impact of FDI on employment. The impact of FDI with regard to the unemployment rate can be determined only indirectly, but clearly. Based on the information regularly provided by the Department of Monetary and Financial Studies a significant positive impact on employment in Slovakia as well as the overall level of work and labour can be concluded.

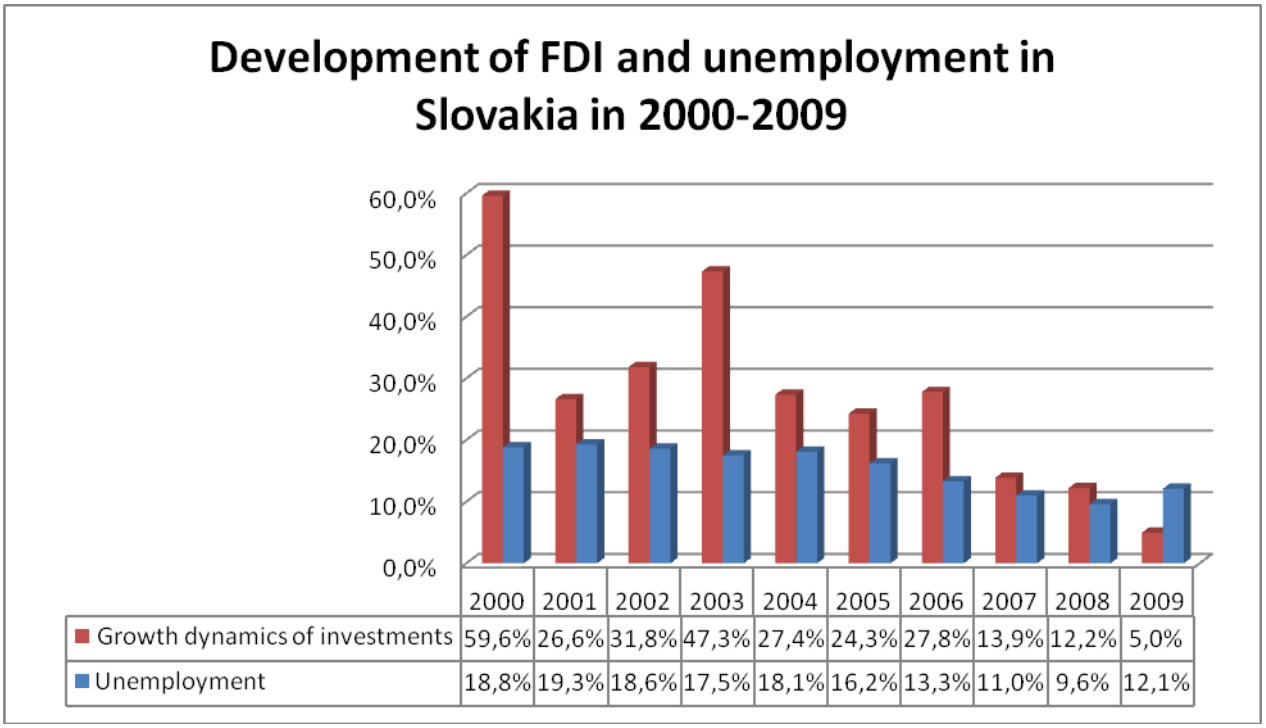


Figure 12 *Development of FDI and unemployment in Slovakia in 2000-2009*

Source: www.nbs.sk and www.ekonom.sk data, own Figure

In Slovakia, there is a significant connection of enterprises, whether with a participation or with a 100% ownership to the internal industry in Slovakia. This factor accounts for multiplication effects in different directions where the most important is employment. When we compare the level of employment and foreign investment inflows a certain relation is observed. Although the unemployment rate is affected by many factors, it is feasible to assume that the entry of foreign investors has a positive effect on labour demand (see figure 12).

It is evident that with the inflow of foreign investment the unemployment decreases and it is also clear that the employment level could not be maintained without the entrance of FDI. The fact that FDI inflows decrease the unemployment is also supported by argument that in regions where Slovakia had the highest inflow of FDI it had the lowest unemployment and vice versa. In this sense, foreign investment can contribute to a regional unemployment decrease which is also a problem in Slovakia. Slovakia has large regional differences in unemployment and they are caused mainly by an uneven inflow of FDI.

Another factor of economic growth is the international transfer of technology and know-how. FDI undoubtedly facilitates technology transfer among partner countries. Foreign investments encourage, with regard to international cooperation, a whole range of activities such as technology, capital, management, know-how and other expert knowledge. Slovakia meets the necessary requirements for investment in high technology, because the population is highly educated (see Figure 13). For a foreign partner this is a truly remarkable opportunity to have a combination of highly educated workforce with low wages (see Table 6), which is one of the major incentives to invest in Slovakia. As for Slovakia as a *...country with a high rate of accommodation to the requirements of the planning system, i.e., a good educational system and well qualified workforce, will attract industry and faster well being.*

John Kenneth Galbraith, 1967

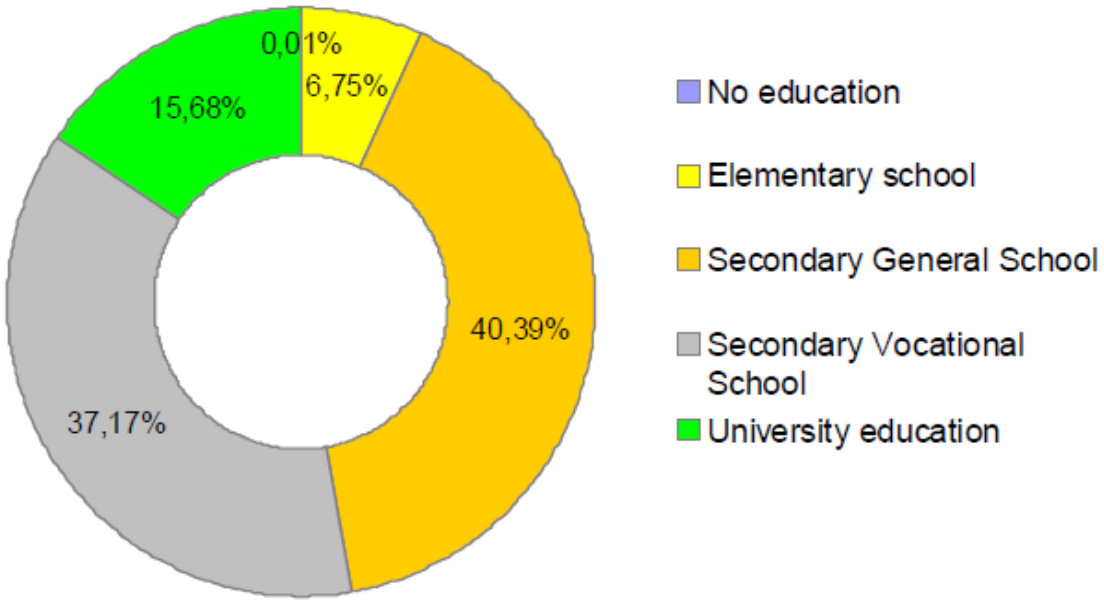


Figure 13 *Education structure in Slovakia*
Source: Sario, Why invest in Slovakia 2010

Conclusion

The assessment of foreign investments and their impact on the Slovak economy leads, despite the relatively short period from 2000 to 2009, to the conclusion that the impacts of foreign investments are more positive than negative. As indicated in the introduction, the roles and forms of realization of foreign capital and its importance to all emerging countries were considered. Foreign direct investments proved the most effective because investors provided capital and effective managerial control. Good investment conditions and a business friendly environment are required for FDI where there is a strong competition among countries. They can be understood as a set of economic, political and legislative conditions.

Because of the foreign investments, the Slovakian economy became clearly more dynamic. It was also concluded that the foreign investment which entered Slovakia helped to ensure long-lasting economic growth.

Based on the development of FDI and its influence on the Slovakian economy in the period from 2000 to 2009 it can be noted that all these effects in recent years positively affected the export policy. Other factors that ensured a sustainable economic growth also developed positively whether it was the growth of GDP, of employment, growth in living standards, household consumption etc. All of these advantages would not exist without the proper preparation of a business-friendly environment (good laws, which encourage investments etc.) for the arrival of foreign investors.

All of these positive results in relation to FDI proved to be effective ways to converge with the developed economies. This can be assessed as a big positive for the Slovak Republic in terms of its future prospects and growth.

This positive trend was slowed down at the end of 2008 because of the global financial crisis. The automobile and electro-engineering industry secured the most exports during the above mentioned growth period which led to another problem, since the financial crisis affected mostly these two industries and thus the Slovakian economy as well. In regard to this fact the current situation in the sectoral focus is very inadequate because the entrance of carmakers with a strong transnational nature caused many difficulties for the Slovakian economy during the period of economic crisis.

The arrival of new investors is unlikely for the foreseeable future (despite the entrance into the euro zone, the good image of Slovakia, favorable legal conditions for entrance of FDI),

primarily because of the present global economic crisis, and this will probably also slow down the growth of the Slovak economy.

One means for the Slovakian economy to attract further investors is to support investments in diverse industries, especially in sectors with higher added value, but also to build a country which creates new products and new technologies.

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V. APPENDIX

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(1) Abstract

Das Ziel dieser Arbeit war es die ausländischen Investitionen und deren Auswirkungen auf die slowakische Wirtschaft zu bewerten und analysieren, insbesondere im Hinblick auf das wirtschaftliche Wachstumspotenzial. Diese Arbeit ermittelte die Rolle der ausländischen Investitionen, die neuesten Trends und die positiven und negativen Auswirkungen von ausländischen Direktinvestitionen (FDI) von 2000 bis 2009 in der Slowakei. Besondere Aufmerksamkeit wurde den ausländischen Direktinvestitionen in der Slowakei gewidmet, die sich auf die sektorale Struktur der ausländischen Direktinvestitionen beziehen.

Außerdem wurde der Beitrag, aber auch die Gefahren der ausländischen Investitionen erforscht basierend auf den Informationen aus dem Zeitraum 2000 bis 2009. In diesem Zeitraum wurden Vergleiche gemacht anhand deren Folgerungen gezogen wurden, ob die Auswirkungen ausländischer Investitionen und vor allem ausländische Direktinvestitionen in die wirtschaftliche Entwicklung der Slowakischen Republik positiv oder negativ eingreifen.

Ein weiterer Schwerpunkt dieser Arbeit war es, den Bedarf an ausländischen Investitionen für die slowakische Wirtschaft hervorzuheben. Anschließend wurde die Entwicklung der ausländischen Investitionen beschrieben die in die Slowakei geflossen sind. Die Slowakische Republik wurde als ein Staat vorgestellt, der verschiedene Investoren trotz der andauernden Finanzkrise anlockt, was dazu führt das weitere ausländische Investitionen in die Slowakei fließen werden auch wenn sich diese in den nächsten Jahren verlangsamen. Diese Arbeit wies auch auf die Bedeutung staatlicher Beihilfen für die Investoren an und auch auf die Wichtigkeit der erschaffenen Institutionen und Legislative, die den Zufluss von ausländischen Direktinvestitionen in der Slowakei fördern.

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Wichtigste Tätigkeiten und Zuständigkeiten	Verantwortlich für die Zufriedenheit unserer Kunden, Auf - und Abbau von Veranstaltungen
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Beruf oder Funktion	Schluchten- und Rafting Führer
Wichtigste Tätigkeiten und Zuständigkeiten	Verantwortlich für die Sicherheit und Zufriedenheit unserer Kunden und für den Spaß am Adrenalin
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Zeitraum	Februar 2006, 2007, 2008, 2009, 2010
Beruf oder Funktion	Skilehrer
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Sonstige Sprache(n)

Selbstbeurteilung	Verstehen				Sprechen				Schreiben	
Europäische Kompetenzstufe (*)	Hören		Lesen		An Gesprächen teilnehmen		Zusammenhängendes Sprechen			
Deutsch	C2	Kompetente Sprachverwendung	C2	Kompetente Sprachverwendung	C1	Kompetente Sprachverwendung	C1	Kompetente Sprachverwendung	C1	Kompetente Sprachverwendung
Englisch	C1	Kompetente Sprachverwendung	C1	Kompetente Sprachverwendung	C1	Kompetente Sprachverwendung	C1	Kompetente Sprachverwendung	C1	Kompetente Sprachverwendung
Russisch	A2	Elementare Sprachverwendung	A2	Elementare Sprachverwendung	A2	Elementare Sprachverwendung	A2	Elementare Sprachverwendung	A2	Elementare Sprachverwendung
Tschechisch	C1	Kompetente Sprachverwendung	C1	Kompetente Sprachverwendung	B2	Selbstständige Sprachverwendung	B2	Selbstständige Sprachverwendung	B2	Selbstständige Sprachverwendung
Ungarisch	B2	Selbstständige Sprachverwendung	B1	Selbstständige Sprachverwendung	B1	Selbstständige Sprachverwendung	B1	Selbstständige Sprachverwendung	B1	Selbstständige Sprachverwendung
Spanisch / Kastilisch	A1	Elementare Sprachverwendung	A1	Elementare Sprachverwendung	A1	Elementare Sprachverwendung	A1	Elementare Sprachverwendung	A1	Elementare Sprachverwendung

(*) Referenzniveau des gemeinsamen europäischen Referenzrahmens für Sprachen

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