

The impact of Institutional Distance on inward FDI inflows in the Czech Republic

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Abstract

This paper studies the impact of Institutional Distance on FDI inflows in a specific country, the Czech Republic. This study contributes to the literature on the importance of Institutional Distance between home and host country among the factors able to influence FDI. The novelty of this paper is that we consider whether Institutional Distance matters also when the host country is already endowed with institutional standards relatively close to those of the main home countries of MNEs. The Czech Republic has been chosen for this reason, as it has traditionally been considered as one of the most developed markets among those issued from the Socialist experience. Results indicate that Institutional Distance affects FDI also to this country as for Corruption but in a sense opposite to what the previous literature suggests. The other variables representing Institutional Distance are not significant.

1. Introduction

This paper analyses the relevance of Institutional Distance for the determination of inward Foreign Direct Investment (FDI) inflows in the Czech Republic. We apply the Gravity Model method traditionally used to study and explain the patterns of International Trade flows but employed also to study the determinants of FDI inflows. The novelty of this paper lies on its underpinning theoretical perspective: the author is interested in studying whether Institutional Distance affects FDI even when it is moderate, the choice of the country (the Czech Republic) reflects this intention. In terms of institutional development, the Czech Republic is one of those former Socialist economies closest to Western standards.

Scholars have been interested in studying the factors underpinning the choice of companies to invest directly abroad since Hymer (1960). Among well-known contributors, Dunning (1980) has proposed that Multi-National Companies (MNEs) decide their international strategies on the basis of the so-called OLI framework known also as the Eclectic Paradigm. Institutions, which are formal and informal constraints affecting behavior of individuals (including economic agents such as MNEs), have received growing attention from among academic researchers which have considered them most relevant to the development of economic processes (North, 1990). The incorporation of Institutions among the factors that affect the determination of FDI patterns reflects a growing attention to the non-economic factors able to influence economic processes in general and FDI in particular. Despite a growing body of

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research focused on studying the impact of Institutions on FDI and MNEs' strategies in general, the role of Institutions as key determinants of the variables has not yet been fully explored. Scholars continue to propose new perspectives and directions of research.

This paper follows the tradition presented above since it is focused on the role of the Institutions among FDI determinants. We are testing the impact of institutional distance on inward FDI inflows to the Czech Republic specifically. Institutional Distance measures the extent of the difference between two institutional environments, i.e., the Czech institutional setting and that of MNEs' home countries investing in the Czech Republic. The effects of institutional distance on FDI and MNEs' strategies have already been studied (Kostova 1997; Kostova and Roth 2002; Yiu & Makino 2002; Xu & Shenkar 2002; Cuervo Cazurra, 2006; Gaur & Lu 2007; Choe & Kumar 2010; Arslan & Larimo 2010; Aleksynska and Havrylchuk , 2013). The authors consider the absolute level of institutional efficiency and also the role distance between the institutional standards in the home/host countries plays for the level of Transaction Costs that MNEs incur.

This paper is focused on a single country, the Czech Republic whose characteristics justify studying a specific country. This country has gone through a process of major institutional transformation after the collapse of socialism and a gradual shift to market regulated economy. The local institutional environment of former socialist (Central and Eastern European) countries (CEECs) has traditionally been pictured as inefficient, under-developed or unsuitable for Transaction Costs reduction. The Czech environment has the characteristics of having been more developed in comparison with CEECs average standards but less developed than the average of Western standards (Hunya 2003; Podda and Tsagdis 2006, 2007; Podda 2010). Appendix 2 provides an example of this intermediate position, presenting an average of the indicators of Corruption in the West as well as in CEECs states (Corruption is a factor related to the institutional environment as the paper discusses). Appendix 2 shows how the Czech Republic appears less transparent than most of Western economies but also less corrupted than most of the former Socialist partners. This paper will show that this specific characteristic has a particular effect. The Czech institutional standards seem to be sufficiently close to Western countries as well as to transitional or developing countries. Consequently, institutional distance between the Czech market and that of home countries should not represent a hurdle for Foreign Investors. The existing literature has already provided evidence that institutional distance, overall, discourages FDI (Choe and Kumar 2010; Arslan and Larimo 2010; Aleksynska and Havrylchuk, 2013). However, the various available studies have tested the impact of Institutional distance using a sample of countries where Institutional distance reached high degrees. Therefore, Institutional Distance seems to matter when sufficiently high. At the same time, MNEs, especially those operating in a globalized world, may have developed a capacity to deal with Institutional distance and solve the constraints that a moderate level of institutional distance poses. In this case, Czech institutional standards would not be considered too far from those MNEs companies (whose domestic markets are generally either in the West or in transitional (e.g., Russia) or developing (e.g., China) economies) are used to in their home countries. The research is pursued with the aim to increase awareness of MNEs' resistance to a moderate level of institutional distance, which has not been given a specific attention in the relevant literature.

The estimation is based on the Gravity Model that has been introduced by Tinbergen (1962) and originally used to explain the determinants of International Trade patterns. Further specifications of the model have been applied to study also the factors affecting FDI (cf. Brainard, 1997; Braconier, Norbäck and Urban, 2005). The Gravity Model postulates that the

exchange patterns depend on specific factors which attract exchanges and others which deter them.

2. Theoretical background

FDI is an economic process which has puzzled scholars for some time. It has not been clear why MNEs needed to internalize part of their market in countries they were not necessarily familiar with rather than operating through arm length transactions. The seminal contribution which helped to solve the puzzle was that of Hymer (1960) who suggested that MNEs invest directly abroad in order to exploit their superior Technological and Monopolistic Advantage. Hymer's contribution spawned a major interest and inspired scholars to develop their own understanding of reasons why companies recur to FDI and conditions that render a country attractive for international investors entering new markets (Buckley and Casson, 1976; Johansson and Vahlne, 1977). John Dunning developed a model called OLI Framework or Eclectic Paradigm which represents a synthesis of previous contributions (Dunning, 1980). The OLI presupposes that MNEs invest abroad when internalizing (I) appears to be the most convenient choice allowing the firm to maximize its Ownership (O) advantages in a given location (L). Companies can operate in/with foreign markets in three different ways. Companies may prefer arm length transactions (import/export), internalize FDI or operate through "Third Ways" (such as franchising or licensing). The choice depends on the perception of convenience with respect to these three options.

Ownership advantages (already conceptualized by Hymer, 1960) are those that confer to the MNE an advantage over foreign competitors, allowing the MNE to compensate for the "liability of the foreigner" (Zaheer, 1995), namely the natural disadvantage that foreigners suffer in an environment they are not familiar with. These particular Ownership advantages are, for example, higher marketing capacities, better technological knowledge or better access to credit and financial resources. Western companies investing in the Czech Republic after the collapse of the Communist regime have, at least for a while, enjoyed such advantages over domestic economic operators. As for the choice of the market where a company can exploit its O-advantages, MNEs prefer markets endowed with specific Location (L) advantages. These can be low wages (important especially for MNEs investing abroad to perform low value-added activities), market size (important for companies wishing to serve local customers), low taxes, or stable economic and political background. As for the choice of the mode of entry, in order to exploit their O advantage in a specific L-endowed country, MNEs recur to FDI when the benefits of internalizing activities abroad (I advantage) exceed those of operating through arm length transactions or Third Ways. Through FDI, MNEs may better control their own market rather than relying on external distributors (when the investor internalizes downstream activities) or producers (when the company operates through upstream internalization).

In turn, Institutions are the humanly-devised constraints which guide and limit the action of individuals and the "rules of the game" (North, 1990, 2005). Institutions are of two main types: formal (written rules) and informal (unwritten norms). Examples of formal Institutions are laws, whereas informal Institutions are codes of conduct, taboos or socially-accepted practices. Institutions are related to the cultural and social background of a given country and are resistant to change (path-dependent). In particular, informal Institutions change slowly and as a result of changes affecting the values diffused in a given society. Various authors have conceptualized Institutions and their importance for economic processes (Powell and Di Maggio, 1983; Scott, 1995; Williamson 1975, 1985, 1986). This paper endorses the definition

and classification of Institutions proposed by North (1990, 2005), where formal Institutions are legal written rules and informal Institutions are unwritten standards of conduct.

Institutions had been already recognized decades ago among the host-embedded factors able to concur to the determination of the L-advantage even if sometimes institutional parameters were not explicitly denominated as such (Aharoni, 1966; Johanson and Vahlne, 1977). Dunning and Lundan (2008) have explicitly incorporated Institutions among the most important L-factors on the basis of a growing body of empirical research suggesting the major role played by these particular local characteristics on the attractiveness of a given country in the eyes of Foreign Investors (Dunning and Lundan, 2008). The attention towards Institutions' impact on influencing MNEs' strategies have grown since the beginning of the last decade (Mudanbi and Navarra, 2002; Kuznetsov and Kuznetsova, 2003; Bevan et al., 2004; Grosse and Trevino, 2005; Podda and Tsagdis, 2006, 2007; Dunning et al., 2009). Scholars have used a set of locally embedded factors to represent institutional environment and chosen various economic variables and a dummy to control for other factors likely to co-determine the inflows of FDI to a given market. The bulk of results indicate that efficient Institutions concur to the capacity of a specific country to attract FDI or, in other terms, Institutions concur to the configuration of the L-advantage. This represents almost an axiom in the contemporary International Business literature.

A particular stream of research has studied the role of Institutional distance among the L-determinants of FDI cross-country movement (Yiu & Makino 2002; Xu & Shenkar 2002; Gaur & Lu 2007; Choe & Kumar 2010; Arslan & Larimo 2010). These particular writers consider that, all other factors equal, MNEs are more likely to invest in countries whose level of institutional development is more similar to that of the home country. The theoretical underpinning of this idea can be found also in the work of Johansson and Vahlne (1977) who had already postulated that MNEs find easier to penetrate markets which are perceived as close to the home market. Psychological distance is given by a set of factors which can be considered related to the North-type institutional environment. The author of this paper follows this particular perspective and intend to apply it to the study of the importance of institutional distance for the determination of inward FDI inflows to the Czech Republic.

The Czech Republic is one of the countries that emerged from the socialist experience (even if at that time Czech Republic along with Slovakia were part of Czechoslovakia). It has traditionally been considered one of the most developed countries among the emerging economies in terms of economic as well as institutional development (Myant 2003). Foreign Direct Investment trends have been studied by various authors (Zemplerova and Benacek, 1997; Zemplerova, 2000; Myant 1999 and 2003; Hunya 2003; Kay, 2007). Appendix 3 and 4 offer an overview of FDI broken down by sector and geographical origin. The Czech Republic offers various L-advantages: a workforce cheaper than in Western countries (even if not as cheap as that of other CEECs or China), an educated and growing market, a favorable geographical location, and a stable economic and political environment. In particular, Institutions in the Czech Republic have so far not been as efficient as average Western Institutions are supposed to be but still safer than those of most other CEECs. This may be due to the historical legacy of the Czech territories having been administered by the Austrian Empire. The indicators of certain institutional parameters like Corruption, Rule of Law, Regulatory Quality suggest that the country performs better than CEECs average (Podda, 2010).

The above points suggest that the Czech institutional environment is safer or not as unsafe as most other CEECs (ex. former Soviet Republics) but not yet as developed as the institutional

environment of most of Western countries (North American and pre-2004 enlargement EU countries). This particular position has a possible implication for the role that Institutional Distance plays among the factors influencing inward FDI inflows to the country. Czech Institutions may be already sufficiently developed to guarantee to MNEs a safe environment but, at the same time, the local setting may present some loopholes which allow certain companies (Western companies but also the MNEs whose home country is located in areas whose institutional development is lower than in the Czech Republic) the possibility to exploit specific institutional characteristics to their advantage (such as capturing the state or avoiding social or environmental law). Hence, institutional distance may not be sufficiently high to represent an obstacle for Western MNEs or countries such as Russia where MNEs may come from.

3. Methodology

Czech FDI inflows represent the dependent variable and are broken down by home country. In turn, the independent variables are 5 proxies of institutional distance, calculated as the arithmetical difference (in absolute values) between the indicator representing the Czech environment and that of the partner country. Scholarly literature has used a long list of proxies or indicators of the institutional environment. Discussing them would be out of the scope of this paper, hence we focus on introducing the variables representing Institutional Distance:

- a) **Corruption ($CR_{dist_{it}}$)**, intended as the abuse of entrusted power for personal gain. Corruption can take various forms, mainly administrative Corruption (bribes) and State Capture (buying the votes of Government Members). In general, corruption has been considered to deter FDI because it raises Transaction Costs and creates Uncertainty (Wei, 2000; Habin and Zuravicky, 2001; Al Sadig, 2009). In particular, Cuervo-Cazurra (2006) has shown how distance at the level of Corruption between the home and the host country matters more than the absolute level of Host-country Corruption. We consider the level of Corruption in the Czech Republic sufficiently close to that in developed economies and other former CEECs or developing economies. Hence, distance should not represent a hurdle for MNEs. Western and Japanese MNEs used to invest globally, including to countries where Corruption is by far higher than in the Czech Republic, are unlikely to fear the Czech environment. MNEs from other CEECs are used to higher standards of Corruption at home and could eventually exploit the moderate level of Corruption in the Czech Republic to secure an advantage (i.e., avoiding the respect of regulations). Hence the first hypothesis.

Hypothesis 1: Institutional distance as for the level of Corruption between the Czech Republic and the home country does not discourage inward FDI inflows to the Czech Republic.

As for measuring Corruption, this author refers to the indicators developed by Transparency International which measures the Perception of Corruption across the world. Countries are classified with an indicator spanning from 10 (absolute Transparency) to 1 (maximum level of Corruption). Institutional distance for Corruption is calculated as the absolute value of the difference between the level of Corruption in the Czech Republic and that in the home country of the MNE.

- b) **Rule of Law ($RL_{dist_{it}}$)** indicator of the institutional environment measures the capacity of local authorities to govern the country through Law. In general, an efficient Rule of Law should find a place among the L-advantages of a given market (Bevan et al., 2004). Moreover, home to host country distance related to the level of Rule of Law should represent an obstacle to FDI. However, Czech standards are not in line with Western average but higher than the average of CEECs. This author postulates that the levels of Rule of Law in the Czech Republic are already sufficiently close to Western standards, so that Western MNEs do not perceive the local environment as representing a threat. On a parallel basis, investors from home countries other than Western ones are often used to local standards which are even less advanced than Czech ones and would hardly perceive the Czech setting as a danger for the implementation of their activities. Hence the second hypothesis:

Hypothesis 2: Institutional distance related to differences in the Rule of Law between the Czech Republic and the home country does not discourage inward FDI inflows to the Czech Republic.

Rule of Law is measured by the World Bank. Institutional distance for the Rule of Law is calculated as the absolute value of the difference between the level of Rule of Law in the Czech Republic and that in the home country of the MNE.

- c) **Democracy ($DE_{dist_{it}}$)** is a government system where citizens can participate directly in the *res publica* and freely elect their representatives (Fisichella, 1990). The impact of host country's Democracy on FDI inflows is controversial from a theoretical point of view. However, empirical evidence suggests that higher standards of Democracy contribute positively to the capacity of a country to attract FDI (Pournarakis and Varkaselis, 2004; Fabry and Zeghni, 2006) since a democratic system is considered to offer a better level of protection against capricious and arbitrary actions of the Government and thus increases Certainty. The Czech path towards Democracy has been clear from the very beginning unlike that of other CEECs (such as Russia or even Slovakia), and is thus considered at the level of Western economies. At the same time, investors from other than Western countries are typically used to governmental systems which are not really democratic and should not feel threatened by the Czech democratic system.

Hypothesis 3: Institutional distance related to the level of Democracy between the Czech Republic and the home country does not discourage inward FDI inflows to the Czech Republic.

Indicators of Democracy are proxied by the parameter Voice and Accountability, developed by the World Bank. Distance between the home and the host (Czech) country is calculated as done in the cases of the other variables.

- d) **Regulatory Quality ($RQ_{dist_{it}}$)** indicates the suitability of existing law to regulate the economy and depends on the clarity and consistency of the local legislation regulations. This parameter concurs to curbing Transaction Costs (Bevan et al., 2004; Dunning and Lundan, 2008). As for the Czech Republic, Regulatory Quality is not low compared to CEECs average standards. However, there have been signals suggesting that regulations during the transition process (and after) have not been clear and consistent, thus creating hurdles to Foreign Investors (Euro-Czech Forum, 2003; Gerls, 2006). This aspect of the Czech institutional setting seems to be the only one among those considered, which may

potentially affect negatively inward FDI inflows to the country. Especially Western investors have found the local setting problematic. As for investors from non-Western countries, used to equal or lower Regulatory Quality at home, they may solve the hurdles created by their domestic inefficient regulations through their network of contacts with local authorities. However, non-Western MNEs do not necessarily have the same advantage in the Czech Republic. Hence the fourth hypothesis:

Hypothesis 4: Institutional distance related to the level of Regulatory Quality between the Czech Republic and the home country affects negatively inward FDI inflows to the Czech Republic.

Indicators of Regulatory Quality are developed by the World Bank. Also in this case, Distance between the home and the host (Czech) country is calculated as done for the other variables.

e) **Property Rights ($PR_{dist_{it}}$)**. Respect of Property Rights is certainly the basic pre-requirement MNEs expect a foreign market to show (Dunning and Lundan, 2009). Respect of Property Rights entails protection of copyrights (and Intellectual Rights in general) and absence of arbitrary expropriation. We propose that the Czech environment is already sufficiently developed in this respect because there have not been significant expropriations of foreign assets. Czech standards in this respect appear substantially closer to Western standards and should not represent an obstacle for MNEs interested in the country.

Hypothesis 5: Institutional distance related to the level of Property Rights between the Czech Republic and the home country does not affect negatively inward FDI inflows to the Czech Republic.

Indicators of Property Rights are developed by Heritage Foundation. Distance between home/host (Czech) country is calculated as done in the case of the other variables.

Inserting Institutional Distance within the Gravity Model would fit the theoretical presuppositions of the model itself. We consider institutional distance a concept similar to Psychological Distance, introduced by Johanson and Valhne (1977, 1990). On the basis of this idea, geographical distance (already included in the original versions of the Gravity Model) and institutional (psychical) distance would represent obstacles for MNEs operating abroad.

These are the Control Variables:

- a) **Geographical Distance (D_i)**, measured as the distance in kilometers between Prague, the capital of the Czech Republic, and the capital of each partner country. Geographical distance is a typical factor included in any Gravity Model. Data are obtained from Open Geo Code.
- b) **Aggregated Market Size of the Czech Republic and the partner country ($GDP_{sum_{it}}$)**. The combined size of the market should be a factor affecting positively the exchange of FDI between two markets. Data are obtained from the International Monetary Fund.
- c) **Aggregated International Trade of the Czech Republic and the partner country ($Total_{trade_{it}}$)** is measured as the sum of import and export occurring from the Czech Republic to its FDI partner countries. Despite the effect of this variable on FDI being potentially ambiguous, FDI may be in principle a complementary or alternative way to carry out International Business. International Trade has been revealed by most empirical studies as affecting FDI positively. Data source is EUROSTAT.

- d) **Aggregated Size of the Population of the Czech Republic and the partner country (Pop_sum_{it})**. This is a classical variable in the Gravity Model. The host and home country population represent potential consumers or clients and are, therefore, important in the determination of the choices of MNEs. Data are from the World Bank.
- e) **Exchange Rate Czech Koruna/Euro (EUR/CZK_{it})**. The exchange rate plays a role in the determination of the FDI a country receives. Various studies have provided empirical support even if the direction of the impact is not clear-cut (Grosse and Trevino, 2005). Data are obtained from EUROSTAT.
- f) **Exchange Rate Czech Koruna/Dollar. (USD/CZK_{it})**. The rationale and data source are the same as for the previous variable.
- g) **Dummy for NAFTA membership (NA_i)**. MNEs from NAFTA members may benefit from the existence of commercial and diplomatic links with EU countries.

Table 1. summarizes descriptive statistics of the mean, standard deviation, minimum, maximum and the number of observations:

Table 1: Descriptive Statistics

	Mean	Standard deviation	Minimum	Maximum	Number of observations
FDI (millions of EUR)	1384.8	3480.1	0.02	28465.34	540
Corruption distance (standardized)	2.16	1.50	0.0	6	500
Rule of Law distance (standardized)	1.56	1.00	0.0	4.25	432
Regulatory Quality distance (standardized)	1.43	1.20	0.0	5.53	432
Democracy Distance (standardized)	1.38	1.30	0.0	5.35	432
Property Right distance (standardized)	2.05	1.40	0.0	5	525
Geographic Distance (km)	2992.4	3335	243.72	9935.95	540
Total trade (EUR)	2.73*10 ⁹	6.65*10 ⁹	5382664	6.07*10 ¹⁰	540
Population sum	1.14*10 ⁸	2.7*10 ⁸	1.02*10 ⁷	1.35*10 ⁹	540
GDP	939.17	1745.38	58.38	11557.11	525
NA (dummy)	0.06	0.23	0	1	540
EU (dummy)	0.43	0.50	0	1	540
EUR/CZK (average value)	31.34	3.97	24.94	36.88	540
USD/CZK (average value)	27.35	6.82	16.96	38.54	540

Source: Author one.

The measure of interdependence is described in the correlation matrix at the end.

This paper makes use of Panel Data analysis as a statistical method suitable to run the analysis. Panel Data method is preferred to other methods (i.e. OLS) whose use and presuppositions are described by various authors (Linnett, 1988; Green, 1991; Mendenhall and Sincych, 2001; Miles and Shevlin, 2001; Bryman and Cramer, 2005; Field, 2005; Tabachnick and Fidell, 2006; Hayes and Caj, 2007). The reason is that Panel Analysis offers the advantage of accounting better for unobserved heterogeneity, i.e., variation that other methods (such as OLS regression) would leave incorporated incorrectly in the error terms.

Panel Data consist of repeated observations of one or more variables in the units of analysis. The two main techniques within the family of Panel Data Methods which can be used for this purpose are Fixed Effects and Random Effects. Both techniques depend on presuppositions and present advantages/inconveniences whose detailed description would go beyond the scope of this paper (for detailed discussions, see Nerlove, 2002; Greene, 2003; Arellano, 2003). The choice is tricky, and both fixed and random effects have been used in Liu et al. (1997) and Cuervo-Cazurra (2006). The author of this paper relies on the Hausman statistical test (Greene, 2003). The Hausman test relies on the assumption that the results obtained through randomizing effects should be considered more reliable when they do not differ significantly from the ones obtained using the Fixed Effect technique. Otherwise, it would be safer to use Fixed Effects. The Hausman test will guide the choice of the technique (Fixed, Random) in the analysis of data.

According to results of the Hausman test, random effects models are used with one-way cross-section specifications. The cross-section examines the short-term (1 year) decision-making, which is rather static. It examines factors behind dependent variable that are common for all investigated years across partner countries. Hence this specification simulates the decision about the selection of the destination market. As for Multi-Collinearity, Variance inflation factor (VIF) indicates which specific variables create problems. As for the key-institutional variables, those whose VIF is above 5 are removed from further models in order to increase reliability of results. As for the control (economic) variables, the author mentions the problem when present. However, no specific models are run in order to better study the impact of control variables, as this would exceed the scope of the paper.

4. Empirical Results

This section presents the results.

Table 2

	Model I	Model II
CR_dist	0,514*** (0,109)	0,502*** (0,108)
RL_dist	-0,519** (0,257)	-0,401** (0,221)
RQ_dist	0,213 (0,237)	---
DE_dist	-0,101 (0,181)	-0,050 (0,771)
PR_dist	-0,165 (0,112)	-0,149 (0,177)
D _i	-0,166 (0,247)	-0,198 (0,244)
GDP _{sum_{it}}	0,539*** (0,171)	0,501*** (0,167)
Pop _{sum_{it}}	-0,624*** (0,226)	-0,549*** (0,210)
Total _{trade_{it}}	0,772*** (0,261)	0,747*** (0,259)
NA _i	0,018 (0,566)	-0,007 (0,989)
EUR/CZK _{it}	3,666 (2,501)	3,377 (2,479)
USD/CZK _{it}	-3,693*** (1,198)	-3,607*** (1,198)
R ²	0,543	0,541
No.obs.	254	254

Notes: Random effect analysis. * significant at 10%; ** significant at 5%; *** significant at 1%. Dependent variable: logarithm of FDI. Variables Geographic Distance, Total trade, Population sum, GDP, EUR / CZK and USED / CZK measured in logarithm.

There are two models, the second is run without Regulatory Quality which was threatening to affect the reliability of results (this is said on the basis of its relatively high VIF). The first remark is that the variable representing Corruption Distance is significant in both models. Nonetheless, the sign is positive and this represents a challenge to the previous literature. It seems that MNEs from those countries which are further from the Czech standards of Corruption, *ceteris paribus*, invest higher amounts of capital in the Czech Republic. In other words, (higher) Corruption distance concurs to the definition of the L-advantages of the

country. This result certainly does not seem to be consistent with the previous literature. This author had thought that the level of Corruption in the Czech Republic could already be sufficiently under control so not to represent a hurdle. However, the fact is that, as long as the analysis suggests, Foreign Investors from more transparent countries (the bulk of originators of FDI to the country) actually see opportunities in the level of Corruption in the Czech Republic. There is one possible explanation. Corruption in the country is, overall, predictable and there are not major abuses from the side of public officials (the country is part of EU, which also operates a sort of supervision, formally and informally). On the other side, certain MNEs may feel that 1) Czech politicians are capturable and that 2) it is possible to save on costs escaping the respect of certain laws (in the field of, for example, environment and social security). This would not necessarily represent an advantage for the country, as it would be unscrupulous investors who would eventually see an opportunity in the possibility to capture the authorities. It seems that these MNEs search in the Czech Republic a fertile ground for escaping the respect of provisions they should indeed respect in their home (less corrupted) countries.

A further key-institutional variable which appears significant in both models is that one representing Rule of Law, in this case the sign (negative) is consistent with the previous literature. The negative sign of the variable representing Rule of Law may appear at odd with the positive sign of the variable representing Corruption. However, we still see a possibility to explain this apparent incongruency. Foreign Investors may appreciate the opportunities that a moderate and predictable level of Corruption may offer in terms of possibility to capture the State or, eventually, avoid the respect of labour and environmental standards. On the other side, Investors may fear certain features typical of a country with a low level of Rule of Law, like for example delays in judicial proceedings and unpredictability of judicial statements. Investors original from countries with the highest levels of Rule of Law would suffer more than others in the Czech Republic because they are less prepared to face the hurdles that a lower level of Rule of Law impose.

As for the other institutional variables, Distance in the level of Democracy (proxied by Voice and Accountability) and Property Rights do not acquire significance. This was expected and is probably because Democracy and Property Rights in the Czech Republic are already sufficiently developed. The impact of Distance in Regulatory Quality was negative and significant in the first model, however the variable was a potential cause of Multi-Collinearity and has been removed from the second model.

Among the non-institutional (economic variables), the two models confirm the significance of two traditional variables of any Gravity Model, namely the sum of the home-host country GDP and the combined home-host country level of International Trade. The appreciation of the Dollar seems to encourage FDI, indicating that the many MNEs are more interested in the possibility to exploit lower production costs in the Czech Republic than in integrating their Czech-based operations into higher value-added activities. The variable Geographic Distance is not significant, this may be because our contemporary technological systems have reduced the hurdles created by Geographic Distance. The sign of the variable representing the combined home-host country level of Population is negative, but this may be due to Multi-Collinearity. Certain economic variables present relatively high values of their VIF, however refining the model further in order to better investigate the impact of non-economic variables would be out of the scope of our paper.

The next step is to move to test the robustness of the results using alternative measures of the indicators of Corruption and Democracy Distance. The indicators of Heritage Foundation for

Corruption and of Freedom House for Democracy are used. This author would gladly have used other indicators also for the other variables representing Institutional Distance, unfortunately these alternative indicators are not available. The results are below.

Table 3 Results with alternative measure

	Model I	Model II
CR_dist	0.444*** (0,108)	0,311*** (0,009)
RL_dist	-0,635** (0,259)	-
RQ_dist	0,312 (0,239)	- 0,165 (0,200)
DE_dist	-0,136 (0,184)	-0,751 (0.164)
PR_dist	-0,167 (0,112)	-0,165 (0,240)
D_i	-0,346 (0,242)	-0,225 (0,244)
Total_trade _{it}	0,410**(0,168)	0,442**(0,169)
Pop_sum _{it}	-0,863*** (0,248)	-0,862*** (0,248)
GDP_sum _{it}	1,080***(0,273)	1,080***(0,273)
NA _i	0,108 (0,574)	-0,108 (0,574)
EUR/CZK _{it}	2,602 (2,506)	2,602 (2,506)
USD/CZK _{it}	-3,197***(1,199)	-3,199***(1,198)
R ²	0,502	0,488
No.obs.	254	254

Notes: Random effect analysis. * significant at 10%; ** significant at 5%; *** significant at 1%. Dependent variable: logarithm of FDI. Variables Distance, Total trade, Population sum, GDP, EUR / CZK and USD / CZK measured in logarithm.

The second table does not contain Rule of Law distance as the VIF of this variable resulted to offend the presupposition of absence of Multi-Collinearity. The results confirm the sign and significance of Corruption, reinforcing the idea that institutional distance is a factor able to attract FDI. The sign of Rule of Law is the same as in the previous set of models, even if significance in the first model is far from being at acceptable levels. As for the non institutional variables, results are overall very similar.

Discussion

The results of the analysis challenge the literature and open new perspectives regarding the importance of Home/Host Institutional Distance in a host country where Institutions are only

moderately developed. The most striking result is that MNEs from institutionally developed countries seem to consider a moderate level of Corruption as an opportunity to exploit, an element which concurs to the L-attractiveness of the host country. An environment where Corruption is overall moderate and predictable seems to represent an interesting opportunity for capturing the State and/or enjoy unfair advantages over competitors and/or escape the respect of certain laws. Unscrupulous investors from very transparent countries, where such opportunities do not exist, may consider that a country like the Czech Republic offers the right combination between the safety of transactions and the possibility to turn local habits about Corruption to an advantage for MNEs. As for the other proxies of Institutional Distance, there is no real effect probably because MNEs from Western countries are not really affected in either way by Czech standards of Rule of Law, Property Rights, Regulatory Quality and Democracy which, despite being lower than home countries' one, are already sufficiently safe. The results of the analysis supports the main theoretical idea underpinning our paper. Four out of our five hypotheses are corroborated by the results

6. Conclusion

This paper has moved from some theoretical ideas supported by empirical results that challenge the previous literature. This study suggests that, contrary to the message presented by the previous mainstream literature, Institutional Distance is not necessarily a hurdle for MNEs, at least when Host Institutions are already moderately developed. MNEs coming from home institutionally developed countries may consider that moderately higher (in comparison with home standards) levels of host market Corruption can represent an opportunity and not a hurdle. Hence, Institutional Distance in this type of case may actually become a L-embedded advantage and not a L-embedded hurdle as previously suggested. This leads to a refinement of the L-dimension of the OLI paradigm, where Institutional Distance was not yet presented under such a perspective. This analysis raises points which may lead to integrate some parts of the OLI framework with some new elements.

It could be useful to formulate some remarks regarding the different FDI sectoral patterns. Unfortunately the currently available data do not allow to break down indicators of Institutional Distance at a sectoral level, hence the issue is left to further investigation. As for geographical (in terms of origin of FDI) patterns, the major donors of capital to the Czech Republic are the USA, the Netherlands, Germany and other developed Western economies. It could be useful to devote further research to study the behavior of MNEs from these countries, especially in view of those international provisions (Foreign Corrupt Practice Act, OECD and UN Conventions ratified in many Western countries) which prohibit bribing abroad. Nonetheless, MNEs may recur to a more sophisticated form of Corruption, namely State Capture, which does not necessarily involves bribes and is harder to be monitored.

Furthermore, it would have been certainly interesting to account for the level of Value-Added of FDI, studying also whether MNEs investing in knowledge-intensive activities follow specific patterns as for their reaction to Institutional Distance in comparison with other types of MNEs. Unfortunately, data do not allow to run such a research perspective, which seems worth of future empirical investigation.

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Appendix 1. Correlation Matrix

	FDI	CR_dist	Rq_dist	RL_dist	Va_dist	Pr_dist	Log(D)	Log(Tot trade)	Log(Popul. Sum)	Log(GDP_sum)	EU	NA	Log(EUR/CZK)	Log(USD/CZK)	Log(inflation)
FDI	1														
CR_dist	-0,583	1													
RQ_dist	-0,635	0,830	1												
RL_dist	-0,633	0,917	0,929	1											
VA_dist	-0,579	0,777	0,890	0,888	1										
PR_dist	-0,516	0,671	0,694	0,698	0,585	1									
Log(D)	-0,348	0,240	0,259	0,225	0,336	0,057	1								
Log(Total Trade)	0,575	-0,148	-0,214	-0,187	-0,239	-0,126	-0,640	1							
Log(Popul:sum)	-0,096	0,382	0,393	0,346	0,446	0,201	0,462	0,151	1						
Log(GDP_sum)	0,421	-0,156	-0,149	-0,204	-0,065	-0,247	0,306	0,421	0,697	1					
EU	-0,509	-0,509	-0,534	-0,485	-0,532	-0,330	-0,575	0,436	-0,366	-0,040	1				
NA	0,117	-0,117	-0,198	-0,198	-0,159	-0,272	0,333	-0,035	0,213	0,423	-0,251	1			
Log(EUR/CZK)	-0,253	-0,253	-0,119	-0,076	-0,086	-0,081	-0,003	-0,275	0,024	-0,171	-0,108	0,011	1		
Log(USD/CZK)	-0,226	-0,226	-0,099	-0,068	-0,080	-0,068	-0,010	-0,242	0,015	-0,162	-0,123	0,007	0,918	1	
Inflation	0,257	0,276	0,114	0,076	0,075	0,098	-0,008	0,280	-0,037	0,150	0,096	-0,016	-0,907	-0,769	1

Appendix 2: A selection of ranked countries as for their standards of Transparency (the higher the rank the lower is the level of perceived Corruption).

Country Rank	Country / Territory	CPI 2014 Score	Surveys Used	Standard Error
1	Denmark	92	7	2.04
3	Finland	89	7	2.05
4	Sweden	87	7	3.41
5	Norway	86	7	2.38
5	Switzerland	86	6	2.61
8	Netherlands	83	7	1.97
9	Luxembourg	82	6	2.78
10	Canada	81	7	2.45
12	Germany	79	7	2.58
12	Iceland	79	6	3.16
14	United Kingdom	78	7	2.09
15	Belgium	76	7	2.26
15	Japan	76	8	3.16
17	Ireland	74	6	4.75
17	United States	74	8	3.74
23	Austria	72	7	3.49

26	Estonia	69	9	2.89
26	France	69	7	2.17
31	Cyprus	63	5	3.92
31	Portugal	63	7	3.36
35	Poland	61	9	2.70
35	Taiwan	61	7	4.17
37	Spain	60	7	3.75
39	Lithuania	58	8	3.85
39	Slovenia	58	9	3.03
43	Latvia	55	8	3.35
43	Malta	55	5	2.63
47	Hungary	54	9	3.45
53	Czech Republic	51	9	2.94
54	Slovakia	50	8	4.07
61	Croatia	48	9	3.25
64	The FYR of Macedonia	45	6	5.92
69	Bulgaria	43	9	2.82
69	Greece	43	7	5.56
69	Italy	43	7	2.26
69	Romania	43	9	3.60
78	Serbia	41	7	2.92
80	Bosnia and Herzegovina	39	6	1.15
110	Albania	33	7	1.51
119	Belarus	31	5	4.04
126	Azerbaijan	29	6	3.02
126	Kazakhstan	29	8	4.40
136	Russia	27	8	2.61
142	Ukraine	26	8	1.64
173	Sudan	11	6	3.55
174	Korea (North)	8	3	3.35
174	Somalia	8	4	2.34

Source: Adapted from Transparency International

Appendix 3: FDI stocks in the Czech Republic (2013) broken down by sector (measured in thousands of Czech Krowns)

Contents	Equity capital	Reinvested earnings	Other capital	Total
AGRICULTURE, FORESTRY AND FISHING	4,667,655	-560,363	674,992	4,782,284
MINING AND QUARRYING	19,951,188	28,221,745	12,119,922	60,292,855
MANUFACTURING	396,362,890	463,928,433	-285,051	860,006,272
of which				
Food products, beverages and tobacco products	43,097,386	25,640,112	19,541,799	88,279,297
Textiles and wearing apparel	10,637,450	870,681	488,809	11,996,940
Wood, paper, printing and reproduction	20,066,330	16,319,750	312,193	36,698,273
Petroleum, chemicals, pharmaceutical, rubber and plastic products	56,391,363	75,655,206	-3,160,333	128,886,236
Basic metals and fabricated metal products	51,657,154	68,208,851	-28,474,562	91,391,443
Computer, electronic and optical products	17,345,388	3,023,616	7,880,578	28,249,582
Manufacture of machinery and equipment n.e.c.	40,260,700	24,860,919	3,670,146	68,791,765
Manufacture of motor vehicles, trailers and semi-trailers	86,576,894	183,725,364	-16,190,444	254,111,814
Manufacture of other transport equipment	4,051,272	3,134,005	-663,545	6,521,732
Other manufacturing (leather, furniture, electrical equipment, repair and installation)	66,278,954	62,489,930	16,310,309	145,079,192
ELECTRICITY, GAS, STEAM AND AIR CONDITIONING SUPPLY	76,225,906	77,500,445	-16,534,323	137,192,028
WATER SUPPLY; SEWERAGE, WASTE MANAGEMENT AND REMEDIATION ACTIVITIES	8,385,004	9,560,011	1,962,026	19,907,041
CONSTRUCTION	31,345,927	16,772,436	-4,948,735	43,169,628
TOTAL SERVICES	697,253,646	442,968,242	265,262,244	1,405,484,132
of which				
WHOLESALE AND RETAIL TRADE; REPAIR OF MOTOR VEHICLES AND MOTORCYCLES	143,932,684	56,341,170	78,056,751	278,330,604
TRANSPORTATION AND STORAGE	42,400,917	19,829,291	4,180,042	66,410,250
ACCOMMODATION AND FOOD SERVICE ACTIVITIES	16,141,143	-11,152,558	4,559,312	9,547,897

INFORMATION AND COMMUNICATION	76,046,608	32,926,609	21,613,528	130,586,745
FINANCIAL AND INSURANCE ACTIVITIES	202,192,298	313,130,066	50,095,907	565,418,270
REAL ESTATE ACTIVITIES	132,000,981	-2,573,852	83,145,821	212,572,950
PROFESSIONAL, SCIENTIFIC AND TECHNICAL ACTIVITIES	68,734,035	29,108,017	17,483,843	115,325,895
ADMINISTRATIVE AND SUPPORT SERVICE ACTIVITIES	11,082,930	4,584,237	5,068,678	20,735,846
EDUCATION	53,559	-133,923	-362	-80,726
HUMAN HEALTH AND SOCIAL WORK ACTIVITIES	1,995,711	1,683,643	447,872	4,127,227
ARTS, ENTERTAINMENT AND RECREATION	900,842	-190,342	147,911	858,411
OTHER SERVICE ACTIVITIES	1,771,938	-706,069	453,806	1,519,675
Other services (for personal consumption)	0	121,954	9,135	131,089
TOTAL except for private purchases and sales of real estate	1,234,300,628	1,038,388,081	258,251,075	2,530,939,785
Private purchases and sales of real estate	69,937,244	0	0	69,937,244
TOTAL	1,304,237,872	1,038,388,081	258,251,075	2,600,877,029

Source: Adapted from the Czech National Bank

Appendix 4: FDI stocks in the Czech Republic (2013) adapted by area of origin (measured in thousands of Czech Krowns)

Contents	Equity capital	Reinvested earnings	Other capital	Total
World	1,304,237,872	1,038,388,081	258,251,075	2,600,877,029
<i>of which</i>				
Albania	0	0	337	337
Andorra	9,105	15,181	56,071	80,357
Argentina	0	0	-56,464	-56,464
Armenia	0	0	-295	-295
Aruba	0	0	553	553
Australia	22,100	40,139	-1,260,512	-1,198,273
Austria	124,468,392	177,061,445	33,365,282	334,895,119
Azerbaijan	0	0	-318	-318
Bahamas	560,142	-23,196	-41,778	495,168
Bahrain	33,300	-3,754	10,161	39,707
Bangladesh	0	0	-23	-23
Belarus	0	0	59,875	59,875
Belgium	28,554,460	63,453,420	11,560,538	103,568,417
Belize	260,368	-133,007	2,375	129,736
Bermuda	42,198	150,959	-84	193,073
Bosnia and Herzegovina	0	0	2,050	2,050
Brazil	0	0	-503,103	-503,103
Bulgaria	112,444	-11,567	-122,835	-21,958
Cambodia (Kampuchea)	113,900	668	-1,331	113,237
Canada	3,187,501	353,273	337,003	3,877,777
Cayman Islands	233,466	782,801	1,297,292	2,313,559
Colombia	0	0	-6,499	-6,499
Croatia	36,911	-56,165	-37,989	-57,243
Curacao	1,032,837	-1,163,691	-842	-131,696
Cyprus	59,478,597	38,754,491	4,134,241	102,367,329
Denmark	9,006,569	4,244,193	3,137,938	16,388,700
Dominican Republic	21,732	-14,746	22,545	29,531

Egypt	1,982	91,588	-9,537	84,033
Estonia	20	0	-2,846	-2,826
Finland	1,881,345	39,121	2,452,742	4,373,208
France	76,371,672	75,615,108	-21,185,325	130,801,455
Georgia	0	0	-32,046	-32,046
Germany	179,091,816	164,161,409	22,097,039	365,350,264
Gibraltar	368,716	-248,591	176,565	296,689
Greece	174,699	-299,569	69,167	-55,703
Guernsey	221,545	-281,759	377,496	317,282
Guinea	176,000	-71,933	0	104,067
Hong Kong	59,504	-1,494,496	122,726	-1,312,266
Hungary	4,828,599	757,136	3,178,478	8,764,213
Chile	0	0	-10,914	-10,914
China	906,877	-686,306	-398,405	-177,834
Iceland	92,804	98,323	617,620	808,746
India	1,862,510	-1,518,761	264,034	607,784
Indonesia	0	0	3,720	3,720
Ireland	2,419,009	420,734	-18,417,441	-15,577,698
Isle of Man	474,192	-107,443	0	366,749
Israel	80,111	103,253	-402,436	-219,072
Italy	17,347,128	3,745,128	3,748,922	24,841,178
Japan	21,939,749	840,776	3,821,209	26,601,734
Jersey	1,893,468	519,315	-1,276,895	1,135,888
Kazakhstan	82,790	-45,411	1,884	39,263
Korea, Republic of (South Korea)	19,269,349	8,617,788	3,008,413	30,895,550
Liechtenstein	7,704,726	-2,937,314	369,460	5,136,872
Luxembourg	80,804,796	7,606,055	71,557,716	159,968,567
Macau	0	0	6,759	6,759
Macedonia, the Former Yugoslav Republic of	0	0	7,902	7,902
Malaysia	300,000	-121,105	73,884	252,779
Malta	5,211,071	-1,686,392	6,647,763	10,172,442
Mauritius	121,323	-119,661	60,940	62,602
Mexico	0	0	-90,589	-90,589
Moldova, Republic of	0	0	-27	-27
Montenegro	0	0	-27,657	-27,657
Morocco	0	0	5,029	5,029
Netherlands	345,556,005	323,720,950	84,809,054	754,086,009
New Zealand	28,228	-40,351	-10,020	-22,143
Norway	1,945,139	260,895	329,903	2,535,937
Pakistan	0	0	-2,923	-2,923

Panama	529,322	-220,937	91,289	399,674
Peru	0	0	388	388
Poland	17,949,108	14,840,021	8,680,601	41,469,730
Portugal	1,198,175	-91,407	122,644	1,229,411
Romania	67,055	-42,506	295,795	320,344
Russian Federation	8,709,501	283,745	-1,168,481	7,824,765
Saudi Arabia	0	0	-16,239	-16,239
Serbia	40,178	-41,702	-218,505	-220,029
Seychelles	1,084,904	-1,791,563	2,778	-703,881
Sierra Leone	0	0	-1,963	-1,963
Slovakia	38,710,488	14,203,923	22,167,400	75,081,811
Slovenia	1,116,291	-1,455,132	2,513,528	2,174,687
South Africa	0	0	96,884	96,884
Spain	55,682,214	18,838,257	2,042,954	76,563,425
Sri Lanka	0	0	1,170	1,170
St Vincent and the Grenadines	310,786	-713,814	27,143	-375,885
Sweden	10,721,661	14,222,440	3,836,567	28,780,668
Switzerland	42,577,867	66,308,985	6,172,198	115,059,049
Thailand	0	0	320,079	320,079
Tunisia	19,656	-4,492	12,417	27,582
Turkey	149,135	-3,399	-520,846	-375,110
Ukraine	52,770	10,069	238,986	301,825
United Arab Emirates	212,997	316,046	-387,344	141,699
United Kingdom	52,624,997	6,477,616	-9,172,394	49,930,219
United States	32,530,505	51,018,480	3,371,582	86,920,567
Uzbekistan	0	0	-835	-835
Venezuela	0	0	-2,652	-2,652
Viet Nam	5,250	0	32,805	38,055
Virgin Islands, British	3,687,625	-1,512,485	1,673,079	3,848,219

Source: Adapted from the Czech National Bank