The Success of the Czech Automotive Industry: 
An Innovative Approach to FDI and Privatization 
For Economic Development and Industrial Upgrading

by

Paul Robert O’Shaughnessy

A Masters Project submitted to the faculty 
of the University of North Carolina at Chapel Hill 
in partial fulfillment of the requirements 
for the degree of Master of Regional Planning 
in the Department of City and Regional Planning.

Chapel Hill

2007

Approved by:

______________________
ADVISOR
Contents

I. Introduction ............................................................................................................................. 4
   What Privatization Promises....................................................................................................... 7
   Criticisms of Neoliberal Theory: An Incomplete Story.............................................................. 8
   Stuck in Reverse: Neoliberal Failure in Developing Country Automotive Industries ............... 9
   Czech Success with FDI and Privatization ............................................................................... 10

II. Privatization Success Story: Škoda Auto........................................................................... 12
   A Valuable Asset ...................................................................................................................... 12
   The Right Moves: Bidding and Sale of Škoda.......................................................................... 13
   Successful Navigation of Post Sale Difficulties ....................................................................... 16
   Privatization Effects on the Supplier Industry......................................................................... 18
   Unsuccessful Privatization in the Czech Republic: Tatra Kopřivnice...................................... 22
   Voucher Privatization: The Wrong Kind of Private Ownership............................................... 24
   Results and Lessons from Škoda Sale ...................................................................................... 28

III. Challenges Beyond Privatization....................................................................................... 31
   CzechInvest: Story of an Effective Public Actor...................................................................... 33
   A Unique Structure ................................................................................................................... 34
   How CzechInvest Helps Automotive Develop......................................................................... 36

IV. In Conclusion: The Pragmatic Path ................................................................................... 39

APPENDIX................................................................................................................................... 41

BIBLIOGRAPHY......................................................................................................................... 47
Acknowledgements:

I would like to take the time to thank Dr. Meenu Tewari for all of her guidance and advice in helping me to make this document relate its story in the most effective and persuasive manner possible. I would also like to thank Ms. Ingeborg Němcová of the University of Economics in Prague and Ms. Cristina Cernusca of CzechInvest for their time and assistance in indentifying the key dynamics of the Czech automotive story.
I. Introduction

Privatization and the opening up of domestic markets to foreign direct investment ("FDI") have been a major focus of world development organizations and especially post-socialist economies, but the track record of these policies as effective mechanisms for economic development has been mixed at best. If these policies are not always effective in creating economic development, when and under what conditions can privatization and FDI be used to foster local economic development and upgrading, and how can public actors play a more effective role in guiding this process?

Privatization proponents advocate the withdrawal of the state from interference in the local economy by selling state-run firms to private owners and opening up the local economy to foreign competition and investment (Sachs & Lipton, 1990, Williamson, 1990, Bhagwati, 2004). These proponents of the free market argue that private firms are more dynamic, more competitive and more efficient than state-run firms. They also claim that opening up the local economy to foreign capital will bring financial and technological investment from foreign firms that will help local industries to upgrade and become more competitive. In this view, privatization and FDI will create economic growth and more competitive local industry through technology enhancing outcomes.

However, widespread evidence shows that privatization is not a panacea and has not always created economic growth and development (Amsden, Kochanowitz, & Taylor, 1994, Stiglitz, 1998). Privatization and FDI have led to disinvestment in the local economy and have undermined rather than upgraded local industries. Often, private investors are motivated to acquire only the most profitable segments of a firm and choose not to invest in making the firm...
competitive as a whole. This leads to a significant contraction of the firm’s operations, a decline in economic output and a loss of local jobs, exactly the opposite of what privatization and liberalization were intended to provide. Local industries can then wind up less competitive than before these policies were initiated. Critics argue that sole reliance on FDI and privatization is an oversimplification of a more complex dynamic. They do not deny that private firms and foreign investment can play a key role in economic development, nor do they contend that state-run economies are superior to market economies. Rather, they claim that simply removing state interference from the economy is not enough by itself to create economic development (Amsden, Kochanowitz, & Taylor, 1994, Stiglitz, 1998, Rodrik, 1999, Sabel & Reddy, 2002).

If privatization and foreign investment can work to create economic development, but are not sufficient by themselves, what are the missing factors in this equation? A growing number of theorists argue that privatization and foreign investment need to be invoked to the extent which is appropriate for the local economy and deployed within a larger framework of local development policies guided by the public sector. Indeed, heterodox theorists such as Amsden argue that the government must actively seek “reciprocity” when selling state-run firms and inviting foreign investors by negotiating conditions with private purchasers that help ensure the desired benefits for the local economy from private ownership and investment (Amsden, 2001). In sum, public actors and development agencies must think more critically and in more specific detail about what benefits they expect privatization and FDI to provide to the local economy and establish clear policies and actions to achieve these benefits (Amsden, Kochanowitz, & Taylor, 1994, Rodrik, 1999).

This paper examines one such case of successful development policy where the instruments of privatization and FDI were used within a larger framework of development
policies and implemented under close guidance from public actors. The paper draws on the case of the Czech automotive industry which has grown impressively since the fall of communism. It has grown through a combination of both free market economics and government guidance. Through a detailed examination of the sequence of steps taken by the state and planning agencies, this paper will provide insights into the specific policies and processes that accompanied successful privatization and FDI in the Czech case to ensure local economic development and industrial upgrading in the economy.

The key information about this case was gathered from interviews with development agency officials in the Czech Republic, local firms, and professors at the University of Economics in Prague. They also provided access to empirical data about the development of the automotive industry in the Czech Republic over the last fifteen years. The information gained from these individuals has been supplemented by peer-reviewed academic research and public news sources to create a continuous narrative of actions and events over the study period.

The paper will first explore further the debate between the proponents and critics of neoliberal development policies in the academic literature before proceeding to a detailed analysis of the Czech automotive industry case. The section entitled “Privatization Success Story: Skoda Auto” begins with a brief description of the state of the Czech automotive industry at the outset of the privatization process. This section proceeds on to recount the actions taken by the government during and after the sale of the largest auto manufacturer and how they were important in creating a solid base for the automotive industry in the Czech Republic under the subheading “The Right Moves: Bidding and Sale of Skoda”. Under the next section, “Challenges Beyond Privatization”, the focus shifts to how the Czech automotive industry has grown and developed since that time and what crucial roles public actors have played in that growth and
development. A final summary will address the new and different role that the state and public agencies have played in guiding local economic development through the process of privatization and market liberalization in the Czech auto industry.

II. The Privatization Debate: Themes in the Literature

*What Privatization Promises*

Privatization emerged as an important policy tool in economic development in the mid-1980’s with the rise of the Thatcher regime in Great Britain. In an attempt to combat the “stagflation” that had afflicted the UK in the 1970’s, the government began a major effort to privatize previously state-owned firms. Sales of state-owned firms such as Cable and Wireless and British Rail were considered to be great successes. These sales raised funds for the government and produced firms which became more economically competitive than they had been previously. The privatization effort was regarded by the British government as a key policy tool in helping the country to escape stagflation (Megginson and Netter, 2001).

The initial success of market-based reforms in the UK in the late 1970’s and early 1980’s gave support to the theory that greater reliance on free markets and less government intervention were the primary keys to economic growth and development. This positive experience of privatization and free market economics grew into a larger economic theory called neoliberalism. Neoliberalism focuses on moving away from protected markets and state ownership in favor of the free market and private enterprises. Privatization, open markets and FDI thus became central tenets of neoliberal economic theory.
Using the fundamentals of neoliberal theory, a specific set of policy prescriptions for economic development was formulated by development agencies in Washington such as the IMF and the World Bank. First enumerated in their entirety in John Williamson’s chapter “What Washington Means by Policy Reform” from his 1990 book, the neoliberal reform agenda acquired the title of the “Washington Consensus” (Williamson, 1990). Drawn mostly from successful experiences with neoliberal reform in Chile under Pinochet and the failure of other Latin American countries’ socialist and import-substitution policies, these recommendations gained currency as the new strategy of economic development in the 1980’s and often became tied to the aid and assistance provided by the World Bank and IMF as conditionalities. It was widely believed that these reforms would trigger economic growth and development, and through the 1990’s, many countries were persuaded to open up protected markets to foreign investors and privatize state-owned firms in exchange for financial assistance from the IMF and World Bank.

_Criticisms of Neoliberal Theory: An Incomplete Story_

Unfortunately, the Washington Consensus did not always provide the development and growth which it envisioned. Some countries which implemented the Washington Consensus to the letter suffered severe economic crises and stagnation while other countries which did not fully implement the Washington Consensus experienced record growth. Argentina, for example, was one major follower of the Washington Consensus which privatized several major industries only to suffer a major monetary system collapse and economic contraction in 2001. Some of the more successful countries, such as China, chose to apply only certain steps from the Consensus and not always in the manner or to the full extent prescribed by the theory or world development organizations. These success stories show that perhaps some of the fundamental thinking behind
the Consensus was sound, but was incomplete in its details and incorrect in the attempt to apply the recommended policies in full measure across many countries with different development situations (Stiglitz, 1998).

Serious criticism has been specifically leveled at the use of neoliberal policy in Eastern Europe. The pursuit of free markets has been characterized as too singular and driven out of personal ideology rather than pragmatism. The model of capitalism adopted in many post-socialist countries was extreme in its simplistic laissez-faire attitude, and the role of institutions and actors other than private actors was largely ignored. The end result was that many countries not only fell further behind Western Europe, but also fell below levels of income and production that had been present under communism (Amsden, Kochanowitz, Taylor, 1994).

Stuck in Reverse: Neoliberal Failure in Developing Country Automotive Industries

The automotive industry in developing countries has been a large industry often associated with national economic development and technological upgrading. Traditionally a state-owned sector, the auto industry became a major focus of neoliberal reform in the 1990’s. The experience of the automotive industry in developing countries with neoliberal policies has generally been negative. Opening up to foreign investment has had particularly negative consequences for some developing nations. When foreign auto manufacturers invest in developing country production without restrictions on sourcing components domestically, they frequently turn to foreign sources. As a result, the domestic industry does not become more competitive, but rather contracts and occupies a smaller, low value-added part of the market where lack of technical capacity is not as great a concern for manufacturers (Barnes and Kaplinsky, 2000).
In South Africa, the automotive industry has historically consisted of foreign manufacturers and domestic suppliers protected by local content restrictions (Barnes and Kaplinsky, 2000). In the 1990’s, the government established the Motor Industry Development Plan (“MIDP”) to develop a globally competitive automotive sector. The MIDP brought down tariffs on imported automobiles and essentially eliminated protection for the components industry. The effect of the MIDP was largely that foreign manufacturers increasingly substituted local components for foreign components. Manufacturers sought to work with global firms which could supply their needs worldwide because of logistical and quality requirements. From September 1995 to 2000, the local content of cars in South Africa dipped from 57.5% to 49.6%. Over the first five years of the new millennium, it was expected that the decline would continue down to 40%. For example, one foreign manufacturer which was not even particularly well integrated into the global operations of its foreign parent saw its direct imports of material rise from 0% in 1993 to 30% in 2003. Local content declined from 50% to 40% and effectively even lower when adjusting for knocked-down assembly components from the parent. Manufacturers were even starting to import heavy components such as metal body parts which are typically sourced locally due to the cost of freight (Barnes and Kaplinsky, 2000).

*Czech Success with FDI and Privatization: Central Argument*

The Czech automotive story stands in sharp contrast to these negative experiences with privatization and foreign investment. Since the fall of communism, the Czech government has directly and through its development agencies championed the cause of private ownership and foreign investment. The industry has not only survived, but even evolved to become a global competitor. As I detail in the rest of the paper, the key difference between the Czech story and the experience in other developing countries like South Africa is the way in which the Czech
government guided and monitored foreign investment. At various stages over the past fifteen years, the government and its development agency, CzechInvest, instituted specific policies to ensure that privatization and foreign investment led to spillovers in the local economy and industrial upgrading.

The foundation for the development of the Czech automotive industry was laid with the privatization of Škoda Auto. What separates the Škoda story from other privatization experiences is that the government successfully identified the best new owner that could turn Škoda into a globally competitive firm. It also sought reciprocity for absorbing Škoda’s debts in the form of pledges to invest in Škoda, target outputs for production and promises to work with the Czech supplier industry. The government did not simply privatize by selling to any private owner without restrictions, rather it found the optimal private partner for Škoda and put restrictions on the agreement which allowed the government to monitor the development of the firm for the first few years after the sale. These policies were rewarded with the rebirth of Škoda as a global competitor. Since its privatization in 1991, Škoda has grown from producing 180,000 cars before privatization to nearly 550,000 cars in 2006 and from 20,000 employees to 23,000 over the same period (www.czech.cz, 2006). The company is currently responsible for 7.7% of the country’s exports (Yahoo News, 2006).

The government’s assistance through its economic development agency, CzechInvest, has also been crucial in spreading the benefits of foreign investment and a free market beyond one major firm to the whole industry. CzechInvest provides important services which address issues such as foreign investment, technological capability, and education, all of which are important to ensuring the competitiveness of this key industry.
III. Privatization Success Story: Škoda Auto

As noted above, privatization has helped to produce economic growth and development, but only in some cases and less often in developing countries. Škoda, however, is a counterexample of a successful privatization story that took place in a developing country. In this section, I analyze what separated Škoda from unsuccessful privatization attempts in other countries.

A Valuable Asset

In the Czech Republic, Škoda has had a long and proud history as an auto manufacturer. From its beginnings in 1895 as a bicycle manufacturer under the name of Laurent and Klement, the company went on to partner with Škoda Plzen, a large arms manufacturer, to mass produce automobiles. Škoda continued to operate through the Great Depression and Second World War. After the arrival of communism, Škoda’s access to Western parts and technology was cut off, but the company was still able to produce relatively reliable models which were noted for their longevity. Connections with the West were not completely severed as Škoda continued to compete in international racing events and export cars to Western Europe, most notably in Britain. Although Škoda was the butt of many jokes in the UK, the jokes served as evidence that enough people in Britain owned Škodas to make such jokes. While Škodas were not the most reliable or attractive automobiles, they were able to maintain some market share thanks to the combination of their price point and durability. Many other models manufactured in the

---

1 One such joke goes as follows:

Q: *Why does a Škoda have a heated rear window?*
A: To keep your hands warm while you’re pushing it.
communist East such as Trabants (East German) or Ladas (Russian) were less common in the West.

In the late 1980’s, the communist government of Czechoslovakia made a heavy push to upgrade Škoda’s production facilities in Mladá Boleslav. Huge investments were made in equipment and design to produce a new model designed by an Italian firm called the Favorit. By 1990, Škoda actually had the most modern production facility in Europe (I. Němcová, personal interview, 2006). With these fixed assets in place and an existing market share in both the Czech Republic and some Western European markets, Škoda attracted heavy interest from Western firms when its privatization was announced. This heavy interest was a result of the government’s prior upgrading efforts and was critical for the future of Škoda. Škoda’s relatively robust production capacity and existing market share in the West improved the negotiating position of the Czech government and its ability to place conditions on the sale. Its smaller gap in competitiveness to the West also meant that it would not take as long for a purchaser to make Škoda a viable global firm.

The Right Moves: Bidding and Sale of Škoda

Once the communist government fell in 1989, many different reforms were undertaken by the new Czech government. One of the main changes was a push to transition to a free market economy. Pursuing the logic of neoliberal development theory, the Czech government decided to privatize its holdings in several major state companies, including Škoda. However, rather than simply soliciting bids and divesting Škoda to the highest bidder, the Czech government used an auction process to create competition between the bidders. The government used this competition to place conditions on the purchaser of Škoda, which helped to ensure that the new owner would be the best partner not only for Škoda, but for the entire Czech automotive industry.
In 1990, the state as sole owner of Škoda engaged in a bidding procedure with several foreign companies for the sale of Škoda. By the end of the year, two major contenders had emerged from twenty-four: Renault and Volkswagen ("VW"). According to the prime minister of the Czech Republic (then part of Czechoslovakia), Petr Pithart, the government was interested in "proposed technology investments," "impact on employment" and "willingness to respect the Škoda name brand" (New York Times, 1990).

It is difficult to know the exact proposal made by Renault, but there were several factors reported in the press that separated the two bids. Most importantly, the proposed investment in Škoda from VW (roughly $5.3 billion) was reported to be much higher than that of Renault ($2.5 billion) (New York Times, 1990). Both companies planned to maintain Škoda as an independent company, but Volkswagen was committed to produce higher-value models with the Škoda brand. Initial plans from Renault were to produce the low-end Renault 19 in tandem with the existing Škoda Favorit, to be joined by another low-end Renault model in the future (Financial Times, 1990).

After winning the bid in December 1990, Volkswagen purchased 31% of Škoda for $175 million and invested $60 million to ensure Škoda’s solvency. It was to invest an additional DM $350 million by 1995 in order to raise its share of ownership to 71% of Škoda. Additionally, Volkswagen was supposed to spend another $3.5 billion on new Škoda facilities including a proposed engine plant and raise production to 400,000 cars by 1997. In return for this investment, the Czech government gave Volkswagen a two-year tax holiday, exempted VW from restitution claims on environmental liability (a major concern for Eastern Bloc firms), and assumed all of Škoda's existing debts (CTK Business News, 1993).
In the bidding process, the Czech government undertook three actions which were very important in the future development of Škoda and the Czech auto industry. First, it selected what it deemed to be the best company as the purchaser, not just the company that would generate the highest revenue for the government. Volkswagen was seen as a financially stronger and more dynamic company with bigger plans for higher-end models at Škoda. Renault would have paid more for the company up front by purchasing 40% rather than 31% of Škoda. This could have been more beneficial in the short term for an indebted government which was in need of funds, but the government chose to go with the purchaser who was the best partner for Škoda.

In fact, Renault’s own state ownership, which could have been seen as a positive from the Czech government’s point of view, seems to have worked against it. Volkswagen was viewed by Czech decision makers as more dynamic and competitive and was a model that the government wanted to follow. According to Miroslav Zamečník, spokesperson for the Czech finance minister, Volkswagen was “the leading European producer”, was “not state-owned, and in the eyes of many, it had better design” (New York Times, 1990, I. Němcová, personal interview, 2006). In tandem with choosing the more dynamic manufacturer, the Czech government also selected the company with bigger plans for Škoda. VW’s planned investment was more than twice the size proposed by Renault, and it planned to produce higher-end models, which allowed for the possibility of a better capital stock and skill base in the industry for the future.

Second, the Czech government successfully negotiated with Volkswagen to accept a set of conditions which essentially effected a transition period for Škoda and its Czech suppliers. The government obtained promises from VW that Škoda would be operated as an independent subsidiary and develop its own vehicles and that VW would not lay off any of the existing workforce. Additionally, VW agreed that Škoda would retain its relationships with its Czech
suppliers and would not supplant them with VW’s global partners. These conditions were crucial in guaranteeing that the whole industry (i.e. both Škoda and Czech suppliers) had time to bridge the competitive gap that it faced and in ensuring that suppliers had a partnership with VW with which they could attract further investment from foreign partners.

Finally, the government chose not to maintain long-term ownership of the company in order to direct its progress. On the contrary, it held the promise of future majority ownership in front of VW as a way to bring the company back to the negotiation table in the future. This proved to be very fortuitous. The government later used VW’s desire to obtain majority ownership to secure explicit guarantees on future investment when the company ran into trouble a few years after the deal. It would seem at first glance that the main advantage of the Renault bid was the possibility for the Czech government to maintain a majority stake in Škoda for the long term. Renault was seeking only a minority share of 40% with no specific plans to increase its stake in the future. However, this advantage would have been a disadvantage in the long run, because it is unlikely that the Czech government could have conducted any future renegotiation of the deal with Renault after the sale because Renault had no interest in acquiring any further shareholding in Škoda.

Successful Navigation of Post Sale Difficulties

The first problems between the new Škoda/VW and the government arose in 1993. In 1992, the International Finance Commission (“IFC”) had announced the approval for a loan in the amount of $700 million to Škoda. Over 1993 and 1994, the proceeds of this loan were to be used by Škoda a.s. to fund the promised investments from Volkswagen that were made at the time of the sale. VW rejected the loan in September 1993 hours before it was to be signed, signaling its unwillingness to deliver on its investment promises (Financial Times, 1993).
contract that was signed by VW, the original $3.5 billion was not explicitly enumerated in the contract and was rather a “signal of intent” on the part of VW. Due to its own poor financial performance at that particular time, VW wanted to reduce the amount of its original proposed investment in Škoda (CTK Business News, 1993).

The Czech government understood that in the face of losses that year, VW could not be expected to meet all of its original promises. Nevertheless, the government used its position as majority shareholder to force talks with the company and put pressure on VW to keep at least some of these promises. By the end of November 1993, the agreement between the government and Škoda was for an investment figure of $1.9 billion and that the engine plant would not be constructed as planned. In May 1994, the new CEO of VW Ferdinand Piech reiterated to the Czech finance minister, Vladimir Dlouhý, that VW would honor this reduced $1.9 billion investment. Dlouhý, somewhat skeptical, threatened that the Czech government would not allow VW to obtain a majority shareholding (as it was to do by 1995) if further adjustments were made in the investment plan (Finance East Europe, 1994). As a result of this pressure, when an agreement was signed in December 1994 which allowed VW to take the majority share in Škoda, the document included specific language which specifically confirmed the $1.9 billion investment in Skoda and set future production targets at 340,000 by 2000 (Financial Times, 1994). This document made sure that the Czech government had a written commitment from VW for future investment in Škoda.

It is quite common that private firms secure benefits from governments such as land or tax breaks in exchange for promises on investment and job creation and that these promises are not filled (Amsden, 2001). Rather than focus on the fact that Volkswagen reneged on its promises, the Czech government used the opportunity to force VW to make firm its remaining
commitments, and it did so with the prospect of the future sale of the majority interest in Škoda. It is likely that the government would have had more difficulty in warding off future cuts in investment with an investor who already possessed what it desired. In the case of Renault, the Czech government could have vetoed Renault’s strategic decisions at Škoda because it would have been the majority shareholder, but it could not have forced the company to invest funds or new technology in Škoda. By holding on to what VW desired, the government was able to more effectively manage the company’s commitment to Škoda. In ensuring this commitment, the government ensured a significant level of investment in Škoda that would still upgrade its capabilities and technology, even if that level was not the same as was originally proposed at the time of sale.

Privatization’s Effects on the Supplier Industry

As noted at the outset, local supplier firms (often small and medium in size) are usually the first to go under after privatization and takeovers. In the case of Škoda, one of the most important pieces of the successful intervention taken by the government is the time period in which the intervention occurred in relation to trends in the automotive industry.

Automotive suppliers have historically been faced with very high standards of quality. Czech component suppliers already had to make very large improvements in technology and quality at the time of Škoda’s sale compared to the situation under communism. In addition, the global parts supply industry was progressively becoming more demanding with original equipment manufacturers (“OEM”) forcing major cost concessions onto their supplier base. Many Western suppliers with modern production capabilities were unable to survive in this environment and were forced out of business. Specific to the Škoda case, VW was at the very forefront of the industry in the demands it placed on supplier capabilities and pricing. Because of
the convergence of these three themes, the condition of maintaining Czech suppliers for a
determined period that the government obtained from VW was very important in the future
development and growth of the Czech supplier industry.

Beginning in the 1980’s, major automobile manufacturers began restructuring their
relationships with suppliers by “tiering” their relationships (Figure One). The system consisted
of three tiers of suppliers: Tier One, Tier Two and Tier Three. Tier One suppliers were to
provide whole systems (drivetrain, suspension, etc.) and were supposed to be the only company
to maintain contact with the OEM. Tier Two suppliers focused on components, Tier Three on
processes and Tier Four on materials.

Through this structure, OEMs were able to force through cost savings onto Tier Ones. Tier One suppliers typically placed great value on their status throughout the 1980’s and 1990’s. They would often cede on pricing maintain their lead role. Additionally, suppliers were expected to be not just local but global partners supplying OEM assembly locations internationally. From 1980 to the present, the supplier base shrunk from approximately 35,000 to about 8,000 due to these demanding conditions (Korth, 2006).

The tiering and restructuring of the supplier base was particularly pronounced in Europe. Because the European automotive industry has historically been characterized by overproduction and stagnant demand, OEMs there push very hard on the supplier base to obtain concessions on price. European production levels are often kept artificially high due to government ownership interests in manufacturers and political interests among labor unions. With such inflexibility in OEM assembly structure and capacity, European suppliers tend to feel the squeeze the most in cost-cutting measures.
This dynamic was also accelerated by the personalities of the era. In the 1990’s, some of those who had helped to restructure the supplier base were rewarded with higher management positions at the major manufacturers. In 1992, Jack Smith was rewarded for his success in increasing GM Europe’s profitability by being promoted to CEO of General Motors. At the time of his promotion, GM's international operations, predominantly represented by GM Europe, earned $2.1 billion, while General Motors as a whole lost $4.5 billion (USA Today, 1993). One of Smith’s key protégés was Jose Ignacio Lopez de Arriortua. Lopez de Arriortua had been largely responsible for GM Europe’s positive performance by extracting savings from GM’s European suppliers, and he followed Smith to become head of GM’s global purchasing division.

Lopez de Arriortua’s ideas with regards to suppliers did not simply involve cost-cutting. He envisioned a complete transformation of the supplier role into “modular production”, where suppliers would complete most of the assembly at a plant and only a handful of the manufacturer’s employees would be present. Lopez de Arriortua envisioned the construction of such a facility in his Basque homeland, but in the economic climate of the early 90’s, GM chose not to move forward with its construction. In 1993, he moved from GM to VW as head of worldwide production under a five-year, $20 million contract. The motivation behind this move was his desire to see a new, modular system implemented in automotive production through the construction of his dream facility in Spain, and it was speculated that VW may have agreed to construct such a facility (New York Times, 1993).

To illustrate the nature of this new role for suppliers, it is helpful to examine the structure of the VW facility that was built in Resende, Brazil in Rio de Janeiro state as it has been the subject of academic research. Built in 1996, it was constructed at the same time and under the same philosophy of Mr. Lopez de Arriortua as the new Škoda facilities in the Czech Republic. At
the Resende facility, 1,500 workers were employed at the plant. Of that, 1,300 were employed by eight subcontractors located inside the facility. Each supplier was required to obtain parts and materials, as well as assemble or install the parts on the vehicle or chassis. This was in direct contrast to all previous auto assembly techniques where suppliers were only responsible for the delivery of parts and systems to the OEM assembler. The role of VW in the plant was mainly to monitor flow and quality of assembly inside the facility in order to ensure reliability of the final product. VW’s payment to its suppliers was based on the sale of product and not on delivery of parts, meaning that much of the inventory for assembly was being financed by the supplier (Abreu, Beynon, Ramalho, 2000). This factory is very similar to the new plants that Škoda constructed in Mladá Boleslav for the new Škoda models during the mid-90’s, and Czech suppliers had to be able to take on these new and demanding roles inside the factory (I. Němcová, personal interview, 2006).

In sum, the competitive gap that faced the automotive supplier industry in the Czech Republic after the sale of Škoda was compounded by industry dynamics as well as dynamics specific to VW ownership. Thus, bridging the gap was a very daunting task. Not only did Czech suppliers have to meet the much higher requirements for quality that all Western OEMs required, they also had to assume pioneering roles inside the factory itself, while still being able to deliver on time at prices that many established Western parts suppliers had difficulty achieving because of VW management. All of this had to be performed in order to survive in the industry.

Therefore, it would seem to be even more crucial that the government required VW to work with Škoda’s existing supplier base at the outset of its new private ownership. VW would much rather have replaced Czech firms with VW global partners and could easily have sourced many of its components from Germany. Mladá Boleslav, which is where most Škodas are
manufactured, is less than 30 miles from the German border at the closest point. But because of the conditions that the government placed on Škoda’s privatization, VW was forced to try and find foreign partners for Czech suppliers so as to upgrade their capabilities as quickly as possible. The promise of guaranteed VW/Škoda business also proved a strong magnet for foreign investors. Czech suppliers certainly needed this foreign investment because it upgraded their processes as well as provided access to a wider customer base through the foreign investor, enabling the Czech subsidiary to grow and diversify away from Škoda business. The current ownership of Czech suppliers reflects this importance of FDI. Figure Two exhibits this dynamic through a selected sample from 2000 of twenty major Czech automotive suppliers. Of these twenty firms, only eight have majority domestic capital (Pavlinek, 2002).

In the years immediately after the sale of Škoda, three major global suppliers (Ford, Rockwell and TRW) bought Czech component suppliers with major Škoda business. Since then, TRW’s subsidiary TAE Benesov has grown from 150 employees to over 600, and Rockwell’s (now ArvinMeritor) subsidiary in Liberec has grown from 400 to over 500 employees and tripled sales from $150 million to $450 million over the period from 1994-1997.

Unsuccessful Privatization in the Czech Republic: Tatra Kopřivnice

The appropriateness of the privatization strategy followed by the government in the Škoda case can be reinforced not only through less positive experiences from abroad, but also from other failed privatizations in the Czech Republic itself. It is important to examine the differences between the Škoda privatization and other less successful privatization experiences to determine the key elements of what made the Škoda story successful.

Tatra Kopřivnice (“Tatra”) was a well known maker of trucks in the former Czechoslovakia. It produced about 15,000 trucks annually and employed 16,000 people during
communism. More than half of this production was sold into other COMECON countries, with about 5,000 exported to the Soviet Union annually (Pavlinek, 2000). Tatra’s sales and marketing operations were handled by the state foreign trade company. After 1989, Tatra faced major competitive difficulties with the new free market structure. Very little was done internally to restructure the company or make it more competitive before its privatization in the expectation that the new owners would fix the company. Due to its poor competitive situation, the only offers which Tatra received from foreign investors were unacceptable to its management. Both Mercedes and Fiat’s Iveco approached Tatra about a sale, but were unwilling to maintain the Tatra brand. Failing acceptable interest from foreign investors, the government exerted direct influence on management to use voucher privatization so that the government would have a famous name for this new privatization program. Tatra management was told that “voucher privatization was the safest way for them because new owners would not understand anything and nobody would interfere in their decision making” (Žák, 1997).

Unfortunately, Tatra needed owners who knew what they were doing as well as investment capital beyond the just the purchase of the firm. Privatizing through vouchers did not provide a path to become more competitive in the market economy because the new owners were no better at running the company than the state. Production declined from 14,586 trucks in 1990 to 1,358 in 1994. In response, the new Czech owners quickly enlisted three US managers to save Tatra in exchange for 15% of the shares (Pavlinek, 2002). Unfortunately, the existing management resisted the new management and would not allow the downsizing of the workforce. The US management could not find new markets for the existing products and was fired in 1994.

Since 1994, Tatra has undergone three more ownership changes and has been in various stages of defaults on its debts and near bankruptcy. Recently, the situation has improved
somewhat. In 2006, the company recorded a small profit of $8 million on the sale of 1,226 units. As of March 2007, the company is scheduled to be sold again by Terex Corporation of the United States, which has deemed Tatra a “non-core asset” (Czech Business Weekly, 2007).

Two major mistakes were made by Tatra managers and the government in this case. The first was to not improve the company before approaching foreign investor about a sale. The second mistake was that when Tatra was privatized, the state and management picked completely inappropriate owners.

Over the period from 1988 to 2000, Tatra trucks won the prestigious Paris-Dakar rally five times (Pavlinek, 2000), so perhaps Tatra management and the state were right to balk at becoming a simple assembly plant for a major Western manufacturer. But while Tatra had valuable technology, its marketing and financial situation were woeful. The state and management should have done something to correct these problems in order to widen the number of purchasers and create a strong negotiating position to place reciprocal conditions on the bids. Instead, the company became a propaganda tool for the voucher privatization project of the Klaus administration, which will be discussed in further detail in the next section. These new owners were inadequate for improving Tatra’s operations and the company suffered severely as a consequence.

Voucher Privatization: The Wrong Kind of Private Ownership

Beyond the individual sale of firms to suboptimal investors, the Czech government later made what could be considered more serious errors by favoring a specific type of privatization, voucher privatization, over other possible methods. In June 1992, the center-right Civic Democrats (ODS) won the parliamentary elections and Vaclav Klaus ascended to the position of prime minister. Klaus, a noted follower of neoliberal economists such as Friedman and Hayek,
was a major proponent of shock therapy and “getting the prices right”, which are very similar to some of the key components of the Washington Consensus.

Klaus implemented policies which eschewed foreign capital in favor of his voucher privatization project. All Czech citizens were afforded the right to purchase a voucher booklet for a nominal fee and use the vouchers for the purchase of shares in formerly state-owned enterprises. Voucher privatization was intended to introduce widespread private ownership in Czech companies as well as to create a shareholder society, but instead was plagued with widespread corruption and graft. Major investment funds sprung up which offered to buy voucher booklets from citizens at a fraction of their worth. Citizens purchased booklets for the printing and distribution cost of 1,000 Czech crowns (Kč or Koruna česka), roughly $30 at that time, and were offered Kč 10,000 ($300) by investment funds to sell their booklets. Through this method, funds were able to acquire major shareholdings in Czech companies such as the brewing giant Pilsner Urquell or industrial manufacturer Škoda Plzeň (Laurent and Klement’s original partner and the genesis of the Škoda Auto brand name) (I. Němcová, personal interview, 2006).

Fraud became widespread, of which one such example was “tunneling”. Lax regulations on cross-shareholdings in related companies allowed funds to acquire existing firms and set up shell companies through which profits were funneled out into personal bank accounts. A manufacturer would sell product at cost or below to the shell company, who would then sell product at market prices. Some firms were also greatly leveraged, providing further funds for crooked owners. When loans went into default, creditors found firms stripped of assets and cash which had been funneled away into managers’ hands. This kind of activity heavily damaged the reputation of the Czech Republic among foreign investors and is partly responsible for stunting
the development of the Prague Stock Exchange and Czech capital market (I. Němcová, personal interview, 2006).

Even when fraud did not take place, firms were hurt by lack of available foreign capital and technology. After Klaus and ODS took power, sales of Czech companies to interested foreign investors were severely curtailed and foreign direct investment was not heavily pursued. This occurred largely because the government under Klaus wished for the voucher privatization experiment to succeed.

The policy had a very negative effect on Czech firms whose technology was outdated and needed investment in new equipment, particularly in the automotive industry. The Klaus government pushed voucher privatization to the exclusion of other alternatives. Some automotive manufacturers were actually recruited to participate in the voucher privatization scheme by the government. Several firms were not able to sell to foreign firms who had access to new technology, techniques and available capital. In one instance, the new government simply dropped a proposal to joint manufacture trucks with Mercedes to produce 75,000 trucks that had been approved by the prior government (Pavlinek, 2000). Also, Czech buyers were allowed to buy firms at their stated book value while foreign buyers had to submit a price proposal. Czech buyers also conducted audits of acquisition targets which sometimes deflated the book value. Thus, Czech firms were often forced to sell to a Czech owner who would leverage the company to make the purchase and then would not be able to invest in the necessary capital and technology to bring the firm up to international standards. According to the director of Temac a.s.,
“We had no illusions about Czech capital. We had this factory assessed by an international audit to find out its value. Then we told ourselves: if a Czech owner comes here, he will borrow X million [Czech crowns] from a bank. Then he will milk the factory and all profits will be used to service the loan. It will take ten to twenty years to pay the loan off and the factory will become outdated in the meantime. After twenty years, the factory could be closed and torn down ... We wanted to privatize our company to save production here and to bring something for the people working in this region.” (Pavlinek, 2002)

Some companies were almost bankrupted by the unavailability of foreign capital. In Figure Two, it is evident that many of the Czech suppliers which were initially privatized through the voucher privatization eventually sold out to foreign manufacturers in the end because they needed access to their technology, capital and customer base.

In 1997, the economy contracted by 0.7% and unemployment rose year on year from 4.8% to 6.5%. Under these pressures, Klaus was forced to resign, ODS was voted out of office and was replaced by the Social Democrats in 1998. The economy continued to shrink in 1998 by 0.8% and unemployment continued to rise hitting a peak in 2000 at 8.8%. Only recently has the unemployment rate declined back around to 7% (Table One). Klaus was elected to the office of president in 2002 (replacing Vaclav Havel who was constitutionally ineligible due to two consecutive terms) where he continues to serve.

The neoliberal theory to which Klaus and his cabinet subscribed espouses the value of private management of the economy and the exclusion of government interference in the market. The irony is, however, that the government interfered greatly in the privatization process to
conduct its voucher privatization experiment. Unfortunately, Klaus’ preferred version of private ownership was detrimental to the competitive position of many Czech companies at a crucial time in their development. In the worst case, it resulted in fraud which caused long-term damage to the image of the Czech Republic as a location to conduct business and stunted the development of its capital markets.

The voucher privatization experience in the Czech Republic thus provides another example that there is not necessarily a direct causal relationship between privatization and economic development. While Škoda’s privatization counts as a success story, the specific method of privatization employed by the government was necessary to complement the efficiencies of private management.

*Results and Lessons from Škoda Sale*

The privatization of Škoda can largely be seen to be successful; Škoda is now partnered with a successful auto manufacturer, it produced 500,000 automobiles in 2006 and continues to employ approximately the same number of people (20,000) as it did in 1990. The automotive industry as a whole employs 130,000 people, accounts for 20% of manufacturing output and 25% of all exports in the Czech Republic. Three major manufacturing plants are now located in the Czech Republic (Škoda, Toyota/Peugeot and Hyundai). The country has the second highest number of automobiles (855,000) produced in Eastern Europe and has the highest number of automobiles produced per capita in all of Europe (Table Two). This number is set to increase when the new Hyundai plant comes on line with forecasted production of 300,000 units annually. This successful case illustrates a key set of questions that need to be answered when undertaking privatization, and indeed many public actions in economic development.
After the fall of communism, the government chose to open the market to foreign goods because consumer welfare was greatly constrained by the restriction of choice in the marketplace. The government wished for domestic companies like Škoda to be competitive in this new domestic market as well as competitive globally. In this new market, Škoda had to improve its quality while increasing efficiency to stay profitable, and this transition required capital as well as new production techniques.

Could privatization provide Škoda with the capital and techniques that it needed to become globally competitive? The answer was yes, but with conditions. The new owner had to have access to the resources Škoda needed (equipment, techniques and capital), and also the desire to provide them. A sale to a globally competitive foreign owner satisfied most of these conditions. Volkswagen had the capital, knowledge and the techniques, but it was unclear to what extent they had the desire to invest in Škoda. This requirement was resolved in two ways: first, through the explicit desire of VW to invest $3.5 billion in Škoda in its bid for the company, and second, through conditions placed on VW by the government to maintain and monitor that desire beyond the simple word of Volkswagen management.

The goal of privatizing the auto industry went beyond the success of Škoda, however. The massive automotive supplier base needed to be upgraded as well. This task proved much more difficult than a simple privatization of each firm to appropriate purchasers. Without Škoda’s business, Czech suppliers would have been left with outdated production methods and no customers at a time when the industry was at its extreme in price competition and demands on suppliers’ capabilities. Under this scenario, it would have been difficult to find any investors for these firms at all, much less firms that would have fulfilled the criteria of having the resources and the desire to fully invest in the Czech company. With such potentially low demand, it also
would have been difficult to obtain any meaningful conditions of sale from an investor. Thus, the government wisely used the sale of its best and most-demanded asset, Škoda, to create better conditions for the privatization of the automotive suppliers. By obtaining a commitment from VW to work with existing Czech suppliers, the government effected two favorable outcomes which greatly increased the possibility of finding appropriate privatization partners. First, it ensured that the privatized firms would have a guaranteed customer that increased the value of the firm to potential purchasers. Second, the government restrictions guaranteed to purchasers of Czech suppliers that the customer with which they would have a guaranteed relationship was Volkswagen, at a time when VW was aggressively whittling down its supplier base into large relationships with key global partners. This greatly increased the demand for Czech suppliers and thus the likelihood that the government could find private partners who had the necessary resources and the desire to invest them in the supplier firms.

On the other hand, it is the failure to answer adequately answer these questions that was the downfall of Tatra and the voucher privatization scheme. Companies were privatized with the intention of making them more economically competitive, but in fact were sold to owners which did not have the resources to ensure their survival in the new marketplace. Simply exchanging a public owner for a private owner did not address the lack of technology, skills and the funds that were needed to enable a privatized firm’s successful transition to the new market economy. Private Czech owners typically did not have access to the resources needed to upgrade privatized firms towards global competitiveness. Even if investment funds or Czech owners had some ability to access the needed resources, the question of their desire to do so was also not adequately addressed. Companies were privatized through vouchers into a society with an inadequate legal structure and many unsophisticated shareholders. The unfortunate fraud that
occurred, such as “tunneling”, is evidence of this lack of desire and the inappropriateness of voucher privatization for economic development and growth.

IV. Challenges Beyond Privatization

It is not simply enough to successfully navigate the privatization process in order to foster economic development. This is simply a beginning. Once a firm or industry has bridged the initial competitiveness gap, many obstacles stand in the way of growth and development of a firm in a global economy.

Resources in a regional or national economy aggregate together to form an equation that creates a certain level of competitive advantage and value. In a simple formulation, infrastructure, the capital stock, the knowledge base and the cost of labor aggregate to create a value proposition for doing business in a country or region. This value is comparable across locations and is important in determining which types of economic activities in a nation can be globally competitive.

Once the country opened back up to FDI in 1997, the Czech Republic combined moderate levels of infrastructure, knowledge and capital stock with a very low cost of labor to create a value proposition for doing business in the country. This value was relatively high, especially for the more labor intensive operations of foreign firms when compared to operating in their home countries or in other developing nations. Major investments in the Czech Republic initially were in the form of production facilities that used a high amount of labor. Examples of such investments are Škoda’s original assembly work in Mladá Boleslav as well as Matsushita and Philips’ major investments in television CRT assembly. However, the cost of labor portion of the Czech Republic’s economic value equation has been quickly eroding due to rising wages.
and the increased competition from globalization. As globalization reduces risks and barriers associated with production in more and more countries, the array of value propositions among nations increases, and the Czech Republic’s advantage in labor costs diminishes when compared against a broader field of competing nations. Additionally, as the economy has grown over the last decade, so have wages, further reducing the cost savings in labor. Already several labor intensive assembly processes once located in the Czech Republic have moved out of the region; Škoda has moved some European assembly work to Poland and Philips has decided to build its new flat screen production facility in Poland as well.

Therefore, the Czech Republic has been forced to increase the other pieces of its value equation to attract new firms and help existing firms grow. Infrastructure, capital stock and particularly labor skills (including management/entrepreneurial skills) must increase as the value provided by cheaper labor decreases over time in order to be economically competitive.

Private firms exist only to maximize profits, not to increase capital, enhance skill sets, or raise wages. Often, investments in these areas are the byproducts of the firm’s attempt to maximize profits, but not always. Firms may choose only to invest in certain areas that help them directly or may not have the ability or resources to upgrade their competitiveness in certain areas. Thus, a need may still exist for another type of actor to provide certain types of resources and assistance in order to for local firms to grow and develop. If the free market process does not necessarily ensure the goal of increased competitiveness among local firms and labor, can public organizations play a significant role in furthering these objectives?
CzechInvest: Story of an Effective Public Actor

The change in government in 1998 marked a significant change in government policies, particularly towards foreign direct investment. FDI was seen by the new government as a key element in promoting growth and development in the Czech Republic. It was through this shift that CzechInvest, a department of the Ministry of Industry and Trade, began its ascendance as the foremost economic development institution in the Czech Republic.

Begun as a small marketing agency in 1993, CzechInvest (“CI”) has grown into a multi-service organization which is the focal point for much of the Czech Republic’s economic development policy today. It has won awards from the European Investment Promotion Agency as IPA of the year for 2000 and 2001. This singles out CI as not only an exemplary agency among the former communist countries of Central and Eastern Europe, but also among the developed nations of Western Europe.

At its inception in 1993, Jan Havelka was appointed manager of CzechInvest. During the rule of the conservative ODS party in the mid-1990’s, it was difficult for CI to prepare attractive services and incentives for foreign investors because the government favored voucher privatization. Despite the lack of political support, CI tried to create clear policies to attract FDI. According to the succeeding CEO of CzechInvest, Martin Jahn, this period of relative obscurity made CI work harder to “prove they (sic) were useful.” During this time, CI worked to develop its relationship with the EU. In the mid-90’s EU funds accounted for 60% of the funding of CI, and CI participated in the PHARE program which gave it access to the Irish Development Agency (World Bank, 2004). The similarities between the two nations were that they both had been European nations with a low level of labor skills and infrastructure as compared to their
neighbors. Ireland had recently undergone major economic growth and was able share some insight with its Czech partners.

The initial cause for CI gaining in credibility and influence had a great deal to do with political maneuvering within the larger bureaucratic structure. Havelka was able to create a good working relationship with both the minister and deputy minister of the Ministry of Trade and Industry as well as with the European Union and CI’s Steering Committee. The eleven-member Steering Committee was selected with the purpose of increasing CI’s networking capabilities; it included representatives from three separate government ministries and the Czech National Bank, as well as four private sector representatives. As the agency has grown, the importance and oversight of the Steering Committee has receded.

A Unique Structure

CzechInvest has the problem of both providing a market service and being a government agency; it is required to satisfy the business community’s needs and maneuver in bureaucratic and political circles. To a certain extent, it is a bit like a private business run by people with bureaucratic experience. Its customers are private firms, which require a quick response and effective products, and its shareholder is the Ministry of Trade and Investment. Through its actions and success, it has gained esteem and goodwill in government ministries, which has been important in helping it to negotiate bureaucratic procedures and obtain funds for its customers.

In creating the company structure, Havelka focused heavily on keeping CI run like a business and worked with politicians to keep bureaucrats out of the organization. According to Havelka, “It is very important to keep an IPA business-like and not to be tempted to turn it into an administrative body due to the governmental nature.” His successor, Martin Jahn, confirms this philosophy. “We are a government agency trying to adopt a private sector management
style” (World Bank, 2004). This style of management has kept CI flexible in its product offerings and responsive to its customer’s needs. CI can only pay government salaries, so it has trouble recruiting experienced talent. It therefore hires talented college graduates who are motivated by the desire to get experience and gives them larger responsibilities than such graduates would get in a normal private sector job.

At its inception, CI was very focused on attracting large greenfield FDI investments such as major assembly facilities from foreign manufacturers. To this end, CI established foreign offices in key developed nations such as the United States and Germany as well as other nations, because CI found that it was too difficult to promote through the Czech embassies abroad. These foreign offices are scored on a unique point system which is meant to effectively direct the activities of the foreign office according to the larger goals of CI (Figure Three).

Foreign promotion was initially very successful as CI landed several greenfield investments for new manufacturing facilities from major foreign investors such as Matsushita and Philips. However, as the global economy slowed at the millenium, CI’s focus shifted away from large FDI projects to attracting medium-sized businesses. More recently CI has included assistance to existing domestic firms across different industries.

As its face to its customers, CzechInvest represents a “one stop” shop in terms of applying for public funds and government and regulatory approvals. The applicant company files with CzechInvest which subsequently navigates the regulatory procedures of the application through various agencies in the larger government. CI gives its business customers an estimation of how long it will take to complete its application at the outset of the process.

Internally, CI is arranged into divisions which provide specific functions and interact with each other. The Department of Investment Development serves as the initial contact with
the applicant firm and locates “new leads” for investments. ID is approached by consultants when the Czech Republic has been shortlisted for a site location. Many times, the whole region (i.e. Poland, Slovakia, Hungary, etc.) has been shortlisted. ID also targets specific firms as desired investors for the country and invites them to events. It profiles its customers and attempts to design products to fit their needs. Through the interaction with its customers, CI can identify areas of needed support for firms in the country. Its business-like operation encourages CI to market itself effectively to firms, and through customer feedback, it develops new ideas for assistance programs. CI compares these programs with other development agency models and creates a final product for firms. The performance of this product is subject to measurables and performance review (similar to the point scoring system for foreign offices), and it is revised as necessary (C. Černusca, personal interview, 2006).

From ID, the customer is passed into project management and/or Investment Project Support, which acts as the face of CI to the client through the rest of the proceedings. Starting in 2007, CI will actually administer a portion of the EU structural funds that the Czech Republic receives, which will total somewhere between $3.5 to $6.5 billion over next six years.

The success of the agency can be measured by more than its control of major investment funds. Since the change in government in 1998, CI has merged most of the other major development agencies of the country under its flag. CI has also administered 771 investment projects at a value of $18.5 billion creating over 153,000 new jobs (CzechInvest, 2006).

**How CzechInvest Helps Automotive Develop**

CzechInvest has secured many foreign investments in the Czech automotive industry from both assemblers and suppliers. CI successfully landed the Toyota/Citroen plant in Kolin and the Hyundai plant in Nosovice, both of which will produce 300,000 vehicles per year. The
Toyota plant is actually the only plant in the parent company which uses almost all local content, which is a testament to the strength of the supplier base in the Czech Republic. Toyota’s exacting standards usually require them to use their Japanese suppliers. Overall, CzechInvest has mediated 170 investments in the automotive sector at a total of $8.1 billion creating over 53,000 jobs. It has been involved with more investment and job creation in the automotive industry than any other industry in the country over its history (Figure Four).

Starting with the change in government philosophy in 1998, the Czech Republic has been offering significant tax breaks and other financial incentives to attract FDI. The eligibility criteria will be changed in 2007, but in general it is aimed at providing long-term, high-value investment into the CR. These funds are available to automotive producers for the construction of a new plant or the expansion and modernization of an existing plant. Half of the investment must be covered by equity (ensuring the seriousness of the investment), at least 40% must be invested in machinery, and a minimum of 50% of that machinery must be high-tech. The investment cannot start before the application for incentives is made, new jobs and investment must be maintained over a period of eight years, and activities must be environmentally friendly. These restrictions aimed at providing more high-end investment seem to be working in CI’s estimation (C. Černusca, personal interview, 2006). These tax incentives are subject to regional restrictions as well. Priority areas have lower investment hurdles for tax relief, and the amount of relief that can be received is also higher for those regions (Figure Five).

The current priority sectors for CI are auto, aerospace, high-tech engineering, micro- and consumer electronics, strategic services (mostly human intensive outsourcing, i.e. call centers and accounting), and ICT (information communication technologies) which is comprised mainly of software, telecom, and biotech/life sciences. Why were these industries targeted? The idea
was to target industries where FDI has been relatively low, that are growth industries, and also have the potential to export. Once FDI starts to come “by itself”, the industry is less likely to be targeted. For example, CI had originally targeted plastics, but once it felt that FDI for plastics was arriving on its own, the industry moved off the list.

From this point of view, it would seem curious that automotive would be included as a targeted industry, but it is higher-end automotive production, such as more technical auto parts and R&D projects, that CI is targeting. CI acknowledges that auto assembly is less value added, and that, over time, production will move to lower cost countries. It is therefore important for the Czech Republic to upgrade the existing industry before labor costs rise too quickly and production moves abroad. Higher value-added production is harder to outsource and is under less competition from unskilled, low-cost labor.

To this end, CzechInvest provides assistance to suppliers of components (especially automotive suppliers) which are located in the country. It maintains a database of all suppliers in various industries and acts as a connection between a foreign company looking to source components from the country and its database of suppliers. An example is Electrolux, which contacted CI about acquiring a Czech supplier, which then in turn made the connection between the Czech company and Electrolux (C. Černusca, personal interview, 2006).

On a more intricate level, CI also has provided supplier development programs over the past five years in its initiative to upgrade the technological capacity of component companies in the Czech Republic. CI uses EU structural funds to run a program where Czech component suppliers can learn about existing and future standards in the industry such as the European Foundation for Quality Management (“EFQM”). Through its contacts with automotive manufacturers, CI can ascertain their requirements (both present and future), communicate them
to the Czech supplier base, and revert back to foreign manufacturers on which suppliers can provide the more technically demanding parts. This communication upgrades the Czech supplier base and encourages foreign manufacturers to locate more technical manufacturing processes in the Czech Republic.

CI also runs a program called IQ Auto which is aimed at providing communication between the industry and technical universities. Investors and producers give information about their needs and requirements for employees, and CI tries to communicate that information to educational institutions so that they can adjust their study programs to provide more appropriately trained graduates. A big need for technical graduates exists among automotive firms, and there is growing enrollment in Czech technical universities. Of the some 300,000 Czech university students, approximately 70,000 are in technical universities and about 8,000 graduate annually.

V. In Conclusion: The Pragmatic Path

In stepping back from the Czech automotive story, what lessons does it offer about the conditions under which economic liberalization and privatization can create economic development? In the aggregate, data can no doubt be used to show that private firms outperform state-owned firms. The most powerful and wealthy nations on earth embrace free markets and the largest and most successful firms are privately held. To stop here, however, ignores the crucial details of understanding the context in which the success of the free market takes place. Cases such as Škoda and CzechInvest show us that while free markets and private ownership may operate well in mature economies, institutions and pragmatic government policies play an important role in helping developing economies reach higher levels of development. Simply
applying black-box theory and expecting development to automatically emerge from the other end is a risky proposition. It is important to think critically in detail about where the economy is, where it is headed, and how its future can be shaped through pragmatic development policies. Hopefully, better descriptions of cases where this has happened will provide greater awareness and a clearer path towards more robust and locally rooted economic development (Rodrik, 1999).

The lesson for economic development planners and development agencies is to analyze in detail what competitive gaps exist in the local economy and assess what policy tools can be used appropriately to bridge these gaps. Privatization and foreign investment can provide solutions to bridging competitive gaps in the local economy, but development planners must specifically identify what kinds of investors will create the best environment for development and under what conditions. When working with private business or foreign investors, it is important for development planners to maximize the strength of their negotiating position and impose conditions that will help monitor desired development objectives. In addition, unmet needs for certain services related to investment or technological upgrading will exist in the market, and development agencies can effectively fill these needs if they are responsive, flexible and have good communication with local industry. As the free market mechanism serves to discipline poor management, development agencies can simultaneously make sure that local firms have the resources they need to succeed in the global economy.
APPENDIX

Figure 1
Source: Korth, 2006

<table>
<thead>
<tr>
<th>Component supplier</th>
<th>Privatisation method</th>
<th>Ownership structure in 2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Almet Hudec</td>
<td>Vouchers 97%, Restitution</td>
<td>Prosperita fund 93% (corporate entity), physical entities 7%</td>
</tr>
<tr>
<td>Královice</td>
<td>Fund 3% (first wave)</td>
<td>Wholly owned Avon subsidiary (foreign capital)</td>
</tr>
<tr>
<td>Avon</td>
<td>Vouchers (first wave), Avon-Rubena</td>
<td>Wholly owned Continental subsidiary (foreign capital)</td>
</tr>
<tr>
<td>Automotive</td>
<td>JV in 1993</td>
<td>Brital (three top managers of Brital)</td>
</tr>
<tr>
<td>Roadit</td>
<td>JV with Continental in 1991</td>
<td>79% of shares</td>
</tr>
<tr>
<td>Continental</td>
<td>(51% of shares)</td>
<td></td>
</tr>
<tr>
<td>Brisk Tabor</td>
<td>Vouchers 41%, Restitution</td>
<td>Wholly owned Duka subsidiary (foreign capital)</td>
</tr>
<tr>
<td>Automotive</td>
<td>Fund 3%, Endowment Fund 1%, NPF 55%—sold to Brital in 1995</td>
<td></td>
</tr>
<tr>
<td>Duka Kabely</td>
<td>Greenfield investment</td>
<td></td>
</tr>
<tr>
<td>Federal Mogul</td>
<td>Direct sale of Ostatk to</td>
<td>Wholly owned Federal Mogul subsidiary (100%) (foreign capital)</td>
</tr>
<tr>
<td></td>
<td>Ferodo, JV between Ferodo</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a.s. and T&amp;N</td>
<td></td>
</tr>
<tr>
<td>Ferko</td>
<td>Vouchers 97%, Restitution</td>
<td>Stark (66% of shares) representing 15</td>
</tr>
<tr>
<td>Strakonice</td>
<td>Fund 3% (first wave)</td>
<td>foreign institutional and private investors</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gamotex</td>
<td>Direct sale to managers and</td>
<td>77% of shares owned by managers and</td>
</tr>
<tr>
<td>Brno</td>
<td>bank representatives in 1995</td>
<td>bank representatives (CHG Company)</td>
</tr>
<tr>
<td></td>
<td>(55% of shares)</td>
<td></td>
</tr>
<tr>
<td>Hayes</td>
<td>Newly built subsidiary of</td>
<td>Wholly owned Hayes Lemmerz</td>
</tr>
<tr>
<td>Lemmerz</td>
<td>Hayes Lemmerz</td>
<td></td>
</tr>
<tr>
<td>HLF, Hlince</td>
<td>Direct sale to four managers</td>
<td></td>
</tr>
<tr>
<td>plant</td>
<td>(100%)</td>
<td>Private owners 100%</td>
</tr>
<tr>
<td>CEEB</td>
<td>Competitive tender—direct sale</td>
<td></td>
</tr>
<tr>
<td>Kabovice</td>
<td>Direct sale to managers</td>
<td>Private owner 100%</td>
</tr>
<tr>
<td>(100%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Karlin Jaromírov</td>
<td>Direct sale to managers</td>
<td>Wholly owned TRW subsidiary (100%)</td>
</tr>
<tr>
<td>(100%)</td>
<td></td>
<td>(foreign capital)</td>
</tr>
<tr>
<td>Lucas</td>
<td>JV with TRW (19%) in 1993</td>
<td></td>
</tr>
<tr>
<td>AutoBohnoy</td>
<td></td>
<td>Wholly owned AutoBohnoy (foreign capital)</td>
</tr>
<tr>
<td>Magnetron</td>
<td>Vouchers 64%, Restitution</td>
<td></td>
</tr>
<tr>
<td>Kostřík</td>
<td>Fund 3%, NPF 54%</td>
<td></td>
</tr>
<tr>
<td>PAL Praha</td>
<td>Direct sale to director and</td>
<td></td>
</tr>
<tr>
<td></td>
<td>top managers</td>
<td></td>
</tr>
<tr>
<td>Hanácké</td>
<td>Direct sale to director and</td>
<td></td>
</tr>
<tr>
<td>Železárny a pírová</td>
<td>top managers (77%),</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Restitution Fund 4%, NPF 19%</td>
<td></td>
</tr>
<tr>
<td>Rubena</td>
<td>Vouchers 70%, NPF 30%</td>
<td>Česká gumírská spořitelná 89%</td>
</tr>
<tr>
<td>Hradek</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Královice</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taneč Ploty</td>
<td></td>
<td>Two private Czech firms—DKU and</td>
</tr>
<tr>
<td>Jaromírov</td>
<td></td>
<td>ECMA Prague—100%</td>
</tr>
<tr>
<td>Tovač</td>
<td></td>
<td>Wholly owned Royal Ecnostra Group</td>
</tr>
<tr>
<td>Zetín</td>
<td>Foreign capital 71%, NPF</td>
<td></td>
</tr>
<tr>
<td>Zvíť</td>
<td>27%, villages 2%</td>
<td>N. V. subsidiary (foreign capital)</td>
</tr>
<tr>
<td>Granáty</td>
<td>Vouchers 45% (second wave),</td>
<td>55% Kamilio Moravský Ben, small</td>
</tr>
<tr>
<td>Zábřež</td>
<td>Restitution Fund (3%), NPF</td>
<td>shareholders 40%, investment funds</td>
</tr>
<tr>
<td></td>
<td>52%</td>
<td>2%, local communities 5%.</td>
</tr>
</tbody>
</table>

Source: Based on 2000 and 2001 interviews conducted by the author.

Figure 2

Source: Pavlinek, 2002
### Table 1

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>-0.7</td>
<td>-0.8</td>
<td>1.3</td>
<td>3.6</td>
<td>2.5</td>
<td>1.9</td>
<td>3.6</td>
<td>4.2</td>
<td>6.1</td>
<td>6.8</td>
</tr>
<tr>
<td>Unemployment</td>
<td>4.8</td>
<td>6.5</td>
<td>8.7</td>
<td>8.8</td>
<td>8.1</td>
<td>7.3</td>
<td>7.8</td>
<td>8.3</td>
<td>7.9</td>
<td>7.1</td>
</tr>
</tbody>
</table>

*Source: Czech National Bank*

### Table 2

<table>
<thead>
<tr>
<th>Country</th>
<th>Population</th>
<th>Cars Produced</th>
<th>Production per 1k Inhabitants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>10,200,000</td>
<td>855,000</td>
<td>83.8</td>
</tr>
<tr>
<td>Slovakia</td>
<td>5,400,000</td>
<td>255,000</td>
<td>47.2</td>
</tr>
<tr>
<td>Poland</td>
<td>38,600,000</td>
<td>580,000</td>
<td>15.0</td>
</tr>
<tr>
<td>Russia</td>
<td>145,000,000</td>
<td>1,000,000</td>
<td>6.9</td>
</tr>
<tr>
<td>Germany</td>
<td>83,000,000</td>
<td>5,300,000</td>
<td>63.9</td>
</tr>
<tr>
<td>France</td>
<td>60,000,000</td>
<td>3,100,000</td>
<td>51.7</td>
</tr>
<tr>
<td>Spain</td>
<td>40,000,000</td>
<td>2,000,000</td>
<td>50.0</td>
</tr>
</tbody>
</table>

*Sources: Wikipedia.org, various news sources, www.autoindustry.co.uk*
<table>
<thead>
<tr>
<th>Measures of Performance</th>
<th>Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of articles and appearances in media</td>
<td>2 points per occurrence</td>
</tr>
<tr>
<td>No. of activities, seminars, conferences participated:</td>
<td></td>
</tr>
<tr>
<td>- organizational involvement</td>
<td>- additional 5 points</td>
</tr>
<tr>
<td>- if exhibits and booths were set up</td>
<td>- additional 5 points</td>
</tr>
<tr>
<td>No. of client meetings and contacts established</td>
<td>1 point per occurrence</td>
</tr>
<tr>
<td>Inquiries for and presenting Association of Foreign Investors (AFI)</td>
<td>1 point per occurrence</td>
</tr>
<tr>
<td>New leads generated</td>
<td>3 points per occurrence</td>
</tr>
<tr>
<td>No. of generated projects*</td>
<td>Category A: 50 points</td>
</tr>
<tr>
<td></td>
<td>Category B: 30 points</td>
</tr>
<tr>
<td></td>
<td>Category C: 20 points</td>
</tr>
<tr>
<td></td>
<td>Category SS: 40 points</td>
</tr>
<tr>
<td></td>
<td>Category SRC: 12 points</td>
</tr>
<tr>
<td></td>
<td>Category RZ: 10 points</td>
</tr>
<tr>
<td>Project follow-ups</td>
<td>10 points per occurrence</td>
</tr>
<tr>
<td>Visits to Czech Republic by potential investors, and future follow-up with those who visited the country</td>
<td>10 points per occurrence</td>
</tr>
<tr>
<td></td>
<td>5 points per occurrence</td>
</tr>
<tr>
<td>No. of completed projects* (official announcements, press releases)</td>
<td>Category A: 50 points</td>
</tr>
<tr>
<td></td>
<td>Category B: 30 points</td>
</tr>
<tr>
<td></td>
<td>Category C: 20 points</td>
</tr>
<tr>
<td></td>
<td>Category SS: 40 points</td>
</tr>
<tr>
<td></td>
<td>Category SRC: 12 points</td>
</tr>
<tr>
<td></td>
<td>Category RZ: 10 points</td>
</tr>
</tbody>
</table>

* Note: Projects are categorized as:

- A for projects with high strategic importance, multinational technology based projects;
- B for projects with total investment amount exceeding or equal to US$20 million that are possible to realize within 6 months;
- C for projects with total investment amount between US$5 million and US$20 million that are unlikely to be completed within 12 months;
- SS for projects in strategic services (as defined by CI);
- SRC for projects that will be sourcing from Czech suppliers;
- RZ for small projects up to US$5 million that are initiated by CI's regional representatives and referred to the foreign offices.

Figure 3

*Source: World Bank, 2004*
Figure 4

Source: CzechInvest
Figure 5

Source: CzechInvest
BIBLIOGRAPHY


