ON THE EARNINGS OF AUSTRIAN AFFILIATES IN THE NEW EU MEMBER COUNTRIES

Dr. Wilfried Altzinger
Vienna University of Economics and BA, Austria
wilfried.altzinger@wu-wien.ac.at

Abstract

Austrian outward foreign direct investment increased quickly since 1989. For Austria this period was characterised mainly by the opening up of Central and Eastern Europe (CEE) economies. In CEE, affiliates are quite young on average, since the earliest date of establishment was 1989 in the majority of cases. It is therefore not surprising, that early date profitability of Austrian affiliates in CEE has been modest. The picture changed considerably during the mid nineties when Austrian FDI in CEE-5 had become very profitable. However, profitability became a second wind when also investments in other CEECs became profitable. In 2003 total annual profits translate into an average return on equity of 6.2%. However, the rates differ quite substantially by region. They are 3.9% for investments in the EU-15 but 8.0 for CEE-5 and 9.6 for CEE-14. The age of investment is the main determinate of profitability. After some severe start-up troubles Austrian affiliates in CEE currently contribute considerable amounts to the overall competitiveness of Austrian MNEs. However, in CEE a particular larger share of total earnings has been reinvested to restructure and reorganize affiliates. Hence, also host countries may have gained from these profits.

Key Words: Austrian foreign direct investment, EU enlargement, profitability.

1 Introduction

The economic and political opening of Central and Eastern Europe (CEE) in the year 1989 has had a tremendous impact on the Austrian economy. Since Austria’s economy is mainly dominated by small and medium enterprises (SME) its outward FDI stock (measured as a percentage of GDP) has been traditionally very low. In 1989, at the beginning of the transition period this share has been 2.1% only whilst the share of inward FDI stock has been 7.0% (see Figure 1). Only 15 years later these shares have increased up to 19.5% and 21% respectively. In 2003 these shares have been rather balanced for the first time in Austrian history. The exceptional increase of Austria’s outward FDI since 1989 was mainly due to the opening up of the CEE economies where Austrian firms invested rather heavily.
Although Austria’s share in worldwide outward FDI stock was 0.7% in 2004, its comparable average share in the eight new member states (NMS) Hungary, Poland, Czech Republic, Slovakia, Slovenia, and the three Baltic states was 8.8% (see Table 1). The largest investors in the region are the Netherlands, followed by Germany. However, Austria is ranked third. In the adjacent countries to Austria these shares are considerably higher, i.e. 23.2% in Slovenia and 14.2% in Slovakia. Moreover, most recent figures show that Austria is ranked first in the next EU-member countries Croatia (27.0%) and Bulgaria (17.5%) and second in Rumania (12.2%) (WIIW 2005). These data show impressively the strong activities of Austrian firms in this region. Most of these activities can be explained by geography but also by cultural and historical ties. The most recent investments in Croatia, Bulgaria and Romania are strongly concentrated in finance and oil processing where Austrian firms have a very strong position generally in CEE. Close to 40% of all outward investment in CEE is allocated to finance!

Table 1: Inward FDI stock in NMS-8 by major home countries
December 2004, share in per cent

<table>
<thead>
<tr>
<th></th>
<th>SI</th>
<th>SK</th>
<th>CZ</th>
<th>HU</th>
<th>PL</th>
<th>NMS-8</th>
</tr>
</thead>
<tbody>
<tr>
<td>Netherlands</td>
<td>5,4</td>
<td>25</td>
<td>30,9</td>
<td>19,5</td>
<td>23,3</td>
<td>21,9</td>
</tr>
<tr>
<td>Germany</td>
<td>7,8</td>
<td>18,5</td>
<td>20,6</td>
<td>29,2</td>
<td>17,2</td>
<td>19,6</td>
</tr>
<tr>
<td><strong>Austria</strong></td>
<td><strong>23,2</strong></td>
<td><strong>14,2</strong></td>
<td><strong>11,8</strong></td>
<td><strong>11,2</strong></td>
<td>4</td>
<td><strong>8,8</strong></td>
</tr>
<tr>
<td>France</td>
<td>7,5</td>
<td>3,1</td>
<td>7,9</td>
<td>4,3</td>
<td>14,5</td>
<td>8</td>
</tr>
<tr>
<td>US</td>
<td>1,6</td>
<td>4,2</td>
<td>5,2</td>
<td>5,2</td>
<td>9,5</td>
<td>6,3</td>
</tr>
<tr>
<td>Other</td>
<td>54,5</td>
<td>35</td>
<td>23,6</td>
<td>30,6</td>
<td>31,5</td>
<td>35,4</td>
</tr>
</tbody>
</table>

Source: WIIW 2005

Until now not much analysis has been carried out on the profitability of Austrian investments (Altzinger 2003, Dell’Mour 2004, OeNB 2005). This present paper tries to shed some new light on this important issue. Section 2 provides an overview on the theoretical determinants of profitability; section 3 describes the dataset and provides the empirical evidence for Austrian; section 4 discusses open questions and concludes.
2 Various Explanations for the Development of Earnings

2.1 On the Determinants of Earnings

As the foundation of an enterprise is frequently associated with start-up losses, the age of the direct investment enterprise provides valuable information. Moreover, we would assume, the amounts invested become larger over time because the risk has become easier to gauge. Also EU membership should decrease investor’s risks considerably. Further, more reinvestments should be encouraged if the upcoming economic development seems to be promising for the host country. Actual research on this topic shows that the average growth rate of transitions countries has been two percentage-points above the growth rate of EU countries on average over the period 1995-2003. Growth acceleration is possible provided the business climate in the EU improves. In any case the average rate of catching-up vis-à-vis the EU will stay at about two percentage points per year.

According to these considerations we expect that the profitability of investments depend among others on (see Lehmann 2002; Lundan 2003):

- Macroeconomic factors (in particular growth rates and risks of investment in host countries)
- Taxes on affiliate income
- Agency problems (between parent and affiliates)
- Transfer pricing

Since actually we do not have the appropriate data to test these considerations we will focus on an easier question, namely on the general development of affiliate earnings over time.

2.2 The Usage of Earnings – Reinvestment or Repatriation?

Firstly, we are in particular interested on the development of earnings over time. Secondly, we want to understand more clearly what has been done with the earnings, in particular whether they have been reinvested in the affiliates or repatriated to the parent firms. Hence we want to test the following hypothesis which is depicted in Figure 2 (see Brada and Tomsik 2003).

At the outset firms made an investment in the host country to found an affiliate. At first, due to start-up problems, affiliates will often operate at a loss (stage 1). In the case of an acquisition, this period may be short if the acquired firm can be easily reorganized to become profitable. In the case of a Greenfield investment, during the time taken to build and equip a production facility, the interest on the capital invested may result in sizable and longer lasting start-up losses. Thus the affiliate operates at a loss and pays no dividends.
Next the affiliate begins to operate at a profit as production starts or as the firm becomes more competitive as the result of the restructuring or other competitive advantages provided by the parent firm (stage 2). However, as the affiliate becomes more successful on the market, it is likely to have significant needs for additional investment. Thus all profits may be reinvested to meet these needs. As time passes and profits continue to grow, the parent firm may begin to require that the affiliate remit some of the profits.

Finally (stage 3), the affiliate has reached a mature stage, the parent firm will choose to repatriate a larger share of profits in the form of dividends so that these funds can be used to finance investment opportunities that offer more dynamic prospects elsewhere, and reinvested earnings will decline.

The two forms of earnings utilization (reinvestment or repatriation) have critical implications for both host and home countries growth and employment. Hence it is essential to get more information on these issues.
3 Development of Austrian FDI and Affiliate Profitability by Countries

3.1 The Regional Structure of Austrian FDI

As shown in Figure 3 Austrian FDI in CEE increased tremendously since 1990. Starting from a low of 405 EUR million in 1990 the amount has increased up to 16.295 EUR million in 2003. In the year 2003 this was a share of 36.8% of total investment and it was for the first time that this share was higher than the EU-15 share (34.5%). Until now Austrian investment in CEE seems to be a never ending story of expansion.

![Figure 3: Austrian Outward FDI by Regions, 1990-2003 (Total capital in EUR million)](image)

This perception seems to be emphasised by the regional structure of Austrian FDI within the CEE-19 (Figure 4). There we can see a very interesting regional pattern of development. Austria started his eastward expansion in 1989 first in Hungary and then in the other three adjacent countries Czech Republic, Slovenia and Slovak Republic. Until 1996 theses four countries accounted for more than 95% of all investment in CEE. However, since 1997 the picture changed considerably. From 1997 onwards first Poland became an important host country for Austrian firms and second several countries within the CEE-14 became much more important. These are in particular the next EU-member countries Croatia, Romania and Bulgaria but also Russia. In 2003 the CEE-14 accounted for 10.9% of total investment whilst Hungary share was only 7.8% and hence turned over by the Czech Republic with 8.0% for the first time. In 2003 the former four most important host countries accounted for 70.4% of total investment in CEE only. Hence it is of importance to look at the profitability also of these new investments in CEE-14 more thoroughly.
To compare the profitability of Austrian affiliates we sub-divide all affiliates into four regions, namely EU-15, CEE-5, other CEE-14 (see endnote 2) and other countries (mainly US, Canada and Switzerland). In section 3.1 it has been shown that the share of CEE-14 has increased largely since 1997.

The profitability of direct investments was not always substantial in CEE. Figure 5 shows the development of the median profitability since 1992. The median provides us a pattern of average profitability of firms independently of their size and impact on total profitability. In particular the development over time can be traced better by the median profitability instead by the average (see also endnote 3).

After 1991, when a wave of investment in the CEECs began, profitability tumbled, even resulting in net losses between 1992 and 1995. During that phase, the percentage of loss making operations rose substantially. Hence the median of profitability was zero for all CEECs. However, this period was characterised by a worldwide recession. Hence also investments in EU-15 show partially huge losses. However, the median of RoE in EU-15 countries was always above that of CEECs.
In the second half of the 1990s, the picture has changed significantly. Profitability in CEE-5 gained a strong wind and has since improved to levels far above those measured in the EU-15. Profitability was boosted, among other things, on the back of the rise in labour productivity (sales per employee). However, the high profitability of affiliates in CEE since 1996 applies only to CEE-5. Affiliates in CEE-14 became profitable in 2000 only. However, since that time the median caught up quickly to the CEE-5 median and took over in 2003. In 2003 the RoE was 3.9% for EU-15 whilst it was 8.0% for CEE-5 and 9.6% for CEE-14 respectively. Hence profitability in CEE has withdrawn profitability in the EU-15 by far.

Looking at the CEE-5 only (see Figure 6) we can see that the upswing in profitability started in all five countries nearly parallel in 1996. Until 2003 all five countries except Poland reached median values on RoE of approximately 10%. Poland is for Austria some exceptional case which is not directly comparable to the other four adjacent transition countries to Austria. Since Austrian investment in Poland started rather late mainly due to geographical reasons (see Figure 4) also the profitability tumbled for a longer period. The best performance was reached in those countries where Austrian investment lasted longest.

Since investments in CEE-14 are more recent ones it is rather interesting to look closer at these developments (see Figure 7). As can be seen from the number in brackets these investments are relatively small in numbers but strongly growing (see also Figure 4). Most of these investments started in the period 1996-2000 and became profitable in 2001 only. However, since then the RoE increased tremendously and very quickly. In 2003 the most successful affiliates have been investments in Croatia (85) followed by those in Romania (54) and in other CEE-11 (108). All of them have improved their RoE to levels close or above those of the CEE-5. Since actual Austrian investments in CEE are strongly allocated to these potentially EU-member countries prospects of Austrian investors seem to be promising.
Since it is quite obvious that the age of investment is a detrimental factor for the profitability we will look at this relation more thoroughly (see Figure 8). There we have pooled all observations for the full period 1989-2003 by regions and years of investment. We can see clearly the strong increase of the median profitability for all regions by age of investment. After the starting-up troubles in the first two years after the initial investment which can be observed independently of the region the median profitability became positive. After the fourth to fifth year of investment the profitability improves strongly.

At that time loss making firms are mostly out of the sample due to bankruptcy. However, in this period we observe rather huge differences in profitability by regions. Affiliates in CEE-5 and even more in CEE-14 reach startling RoE. Investments with an age between six to eight years show in CEE a median profitability twice to three times as high as those in the EU-15.

Since it is the age of investment which explains us most of the different profitability it is of interest to have a look at different vintages of investments by regions (see Figure 9). What we can see clearly is that the share of investments in CEE diminishes dramatically
by the age of investment. Whilst the CEE-share of investments with an age below ten years is on average 41% this share is 21% for older investments only. Hence it is almost certain that total earnings of CEE-affiliates will increase further.

![Figure 9: Distribution of Affiliates by Region and Age of Investment, 1989-2003 (N=24,846)](image)

### 3.3 Are the Earnings Reinvested or Repatriated?

Finally, we want to have a look at the issue what happens with the earnings of these investments. Are they reinvested or repatriated back to the parent company? As already outlined in section 2.2 we expect that the share of reinvested earnings will be rather huge at the early stage of investment but will decline by the age of investment. For simplicity we compare only two regions, namely EU-15 and CEE-19 (see Figure 10). We can see at least two important features. First, the share of repatriated earnings in CEE-19 was very high within the early transition period 1989 to 1990. This exceptional huge share can be explained because at that time investors opted exclusively for projects with a guaranteed high return in the uncertain period following 1989 by probably making quick profits without any long-lasting investment objectives.

However, these two years were something exceptionally. From 1991 to 1995 the share of repatriated earnings was rather similar to the EU-15. However, since 1996 this share is always far below that of the EU-15. The main reason for this is that by far the largest part of total earnings has been reinvested due to strong restructure needs of the existing affiliates. Only in the very recent years the share of repatriated earnings increased slightly.
Comparing the share of repatriated earnings by age of investment (see Figure 11) we see the expected pattern for both regions. The older the affiliates are the more they repatriate to the parent firm. However, the share of repatriated earnings in CEE-19 is always below that of the EU-15. Also this pattern emphasizes that the need for reinvestments to reorganize and reconstruct the new affiliates in CEE is much more urgently than those within the EU-15. Hence both figures demonstrate the strong shares of reinvestments in Austrian affiliates in CEE. We may conclude that these investments do not only improve the competitive strength of the parent company but also the overall competitiveness of the host countries.

4 Conclusions

Mainly due to the opening-up of the CEECs Austrian foreign direct investment increased rather strongly since 1989. This development has enforced Austrian international economic activities considerably. Starting from nearly zero in 1989 Austrian investment in CEE accounted for 36.8% of Austrian total outward investment in 2003. It was for the first time that this share was higher than the EU-15 share (34.5%). Austrian investments in CEE started in 1989 with many loss making investments. However, current investments are rather profitable. Most of the so-called
start-up troubles are already over. In 2003 total annual profits translate into an average return on equity of 6.2%. However, the rates differ quite substantially by region. They are 3.9% for investments in the EU-15 but 8.0 for CEE-5 and 9.6 for CEE-14. In particular also the most recent investments in Croatia, Romania and other CEECs became very profitable. The age of investment is the main determinate of profitability. However, controlling for age of investment, affiliates in CEE are more profitable than in EU-15. Finally, Austrian affiliates in CEE reinvest much larger shares of their earnings than affiliates in EU-15. These investments are urgently needed for the tasks of reorganisation and restructuring of existing affiliates. However, this may help also to improve the overall productivity of host countries. The remarkable profitability of Austrian affiliates in CEE confirms the wide-held impression that the opening-up of CEE economies has helped to improve the overall competitiveness of the Austrian firms considerably.

Notes

1 This research has been financed by the German FESTO company. The author is grateful for their scholarship.

2 Although eight out of 19 CEECs are already member of the EU we subsume under the heading of CEE-5 Poland, Hungary, Slovenia, Slovak Republic and Czech Republic. Under CEE-19 we subsume CEE-5 and Albania, Bosnia and Herzegovina, Bulgaria, Estonia, Croatia, Latvia, Lithuania, Moldavia, Romania, Russia, Serbia and Montenegro, Slovak Republic, Ukraine and Belarus. The eight new member states are termed NMS.

3 We measure profitability by return on equity (RoE). This is net profit (excluding profits and losses carried forward) by the year divided by equity (minus profit or loss for that year). Two indicators for the RoE can be calculated: Firstly, an average RoE by countries or regions which is the total sum of net profits dived by total equity of countries, regions or sector with aggregate data. Secondly, the median of RoE can be calculated with firm level data only. The first measure can be strongly biased by a few large (loss or profit) making firms. The second measure provides a more general pattern of the development. We have to add that only the aggregate data are publicly available. The firm level data have been calculated by senior officials at the Austrian National Bank by request only. I gratefully acknowledge the statistical support from Rene Dell’Mour and the access to data provided by Aurel Schubert from the Department of Balance and Payments. In this paper we calculate and discuss median values only.

References


WIIW. 2005. (The Vienna Institute for International Economic Studies), *WIIW Database on Foreign Direct Investment in Central, East and Southeast Europe, Opportunities for Acquisition and Outsourcing.* Vienna.