Investment Policy in Hungary
– An Agenda for Action

CUTS – C-CIER

Budapest University of Economic Sciences and Public Administration

Dept. of Business Economics

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PREFACE

The economy of Hungary came to be heavily dependent on the activities of transnational corporations (TNCs). The Hungarian experience showed that it benefited from the involvement of TNCs in the short run. Future prospects are, however, less clear.

The Hungarian success story of economic restructuring through foreign direct investment (FDI) ended by late 1990s. Privatisation and major structural changes in the economy were accomplished resulting in rapid increases in productivity levels and income generation. However, many of the factors responsible for this quick improvement were short-term in nature. Their impact exhausted in due course.

Once Hungary joins the European Union (EU), many changes in the overall economic environment will be felt as some of the prevailing and efficient investment attraction tools are prohibited in the EU. The high level of wages in the economy is likely to continue that would weaken one of the most important competitive factors of the country: cheap labour. The future of the FDI-determined development model is therefore not clear now.

The changes in the environment of the Hungarian economy call for urgent steps that should be initiated by the Hungarian Government to secure the country's attractiveness as an investment destination and in the longer run, to strengthen and develop locational advantages of the country. Instead of fiscal incentives alone, improved spatial conditions have to be provided. In place of special processing zones, industrial parks that really work and can perform are needed. The basis of the long-term competitiveness of the country is dependent on an improved supply of qualified labour and quality infrastructure in the country. This paper discusses these and other issues of current and long-term capital attraction capacity of Hungary.

November, 2003.

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LIST OF ABBREVIATIONS

BoP	Balance of Payments
CSO	Civil Society Organisation
CUTS	Consumer Unity & Trust Society
DFID	Department for International Development
EU	European Union
FDI	Foreign Direct Investment
IFD	Investment for Development
IGOs	Inter-governmental Organisations
IT	Information Technology
M&As	Mergers and Acquisitions
NRG	National Reference Group
TNCs	Transnational Corporations
UNCTAD	United Nations Conference on Trade and Development

CHAPTER-1

Introduction

Hungary was regarded as one of the most successful transition economies in Central Europe. Transition process was quick and rather straightforward. Market economic institutions got established. Though most of the economic structures that were designed for the needs of the command economy had to be given up, the destruction of capacities and jobs was counterbalanced by the impressive development of new business structures. Hungarian-owned new small and medium-sized entities were established in many labour intensive businesses. Meanwhile, the deep restructuring of manufacturing was mainly carried out through FDI. Hence, FDI played a decisive role in the economic restructuring and modernisation of manufacturing industries in Hungary.

The high level of FDI penetration in practically all important manufacturing sectors was a result of high attractiveness of economy, as well as of a series of successful capital attraction policies. Hungary's advantageous location in Central Europe, a sufficiently developed infrastructure network, and cheap and educated labour force were important advantages. The privatisation policy was aimed at quick cash sale of state owned firms mainly to foreign investors. Also, a fairly generous tax holiday system, and the possibility of establishing industrial free-trade zones in the country, supported investments. These policy tools were coupled with contributions of local governments producing favourable investment conditions in many locations. As a result, the stock of greenfield investment started to grow. However, this development path was concentrated geographically. The capital city received bulk of investment, besides 4-5 other major industrial centres in the northeast. The remaining parts of Hungary received very little investment.

The turn of the century brought important changes in investment trends. The inflow of FDI started to decrease, and transfer of profits abroad started. Also, Hungarian based companies started to invest mainly in other transition economies of the region. As a result, the net positive FDI balance diminished, and for the first time after the transition in the first quarter of 2003, it became negative. Though the 2002 decline in inward FDI was less dramatic in transition economies than elsewhere, the Hungarian figures show a number of important changes in the composition of FDI flows.

Inward FDI started to decline by late 1990s, and 2001 revival was due to intra-company loans rather than investments. On the other hand, the stock of FDI continued to increase in Hungary, since most firms reinvested a major part of their profits. The composition of the FDI stock increment changed: net new capital inflows declined, loans and reinvested profits took precedence. Also, the sectoral composition changed, with services and trade taking over the manufacturing sector. Manufacturing investors' hesitation to launch new projects in Hungary was evident, when it did not receive any new investment in the automobile industry in recent years.

As far as outflows of capital are concerned, repatriation of profits, royalties and fees increased together with loans. These cost items started to play an important role in balance of payments. The increasing role of these transfers and profit repatriation drove the capital balance into red. However, their increasing role shows that Hungarian affiliates started to earn profits and were successful.

Transfer pricing is widespread but the reasons of transfer pricing may be very different. Hidden profit repatriation used to be the primary suspect, but in the case of Hungary this was not so. The important foreign firms received corporate tax holidays, and were interested in channeling profits to Hungary, and not vice versa. Actually, the transfer of profits to Hungary was observed in many cases when Hungarian affiliates of various TNCs reported unexpectedly high profit margins in the country. Still, the levels of business services' costs, and repaid loans continuously rose indicating a different rationale in the background of these transactions.

The changing patterns of capital flows need some more analysis. There are various possible determinants in the background that have important policy relevance. These changes can be interpreted also as the end of the first phase of investment in Hungary. The new phase will be based on different properties, and will therefore require a redefinition of important elements of economic policy, including investment promotion.

The Investment for Development Project

The Investment for Development project (IFD project) is being conducted by Consumer Unity & Trust Society (CUTS), India, in collaboration with United Nations Conference on Trade and Development (UNCTAD) and is supported by the Department for International Development (DFID), UK. It is aimed at identifying key issues regarding Foreign Direct Investment (FDI) policy in select developing/transition economies, namely, Bangladesh, Brazil, Hungary, India, South Africa, Tanzania and Zambia. Budapest University of Economic Sciences and Public Administration, Budapest is working with CUTS as the partner organisation in Hungary on this project. During the course of the project, experiences and policy issues common to developing countries have been identified and discussed at national and regional seminars, as well as in project meetings.

National Reference Group (NRG) Meetings

A National Reference Group (NRG) was created in each country at the onset of the research. The purpose of the NRG was to get inputs from civil society on FDI and key policy issues. Research reports were submitted to NRG members and discussed at meetings held along the project.

Organisation of the Report

After this first chapter on introduction, Chapter two identifies the most important features of capital attraction in Hungary for 1990s, and analyses how they changed and lost importance by the end of the decade. Chapter three makes a more thorough analysis of FDI-related capital flows. The fourth chapter deals with stakeholders' views on FDI. Chapters five, six and seven draw out an agenda for action by the government, civil society and inter-governmental organisations respectively. Finally, Chapter eight gives a brief conclusion.

CHAPTER-2

The Changing Capital Attraction Factors

The above description of the changing structure of FDI inflows and FDI stock in Hungary indicates a shift in the investment attraction potential. The impact of once successful attraction factors started to diminish. Investors' interest turned to other investment targets. Under the given conditions, the capital absorption capacity of the country might also have reached saturation levels. The decline in both the demand and the supply side is interpreted here as an end of a period of capital attraction. A revival of capital inflows requires the establishment and strengthening of new attraction features. The argument is supported by several facts.

The privatisation process is completed in Hungary. By late 1990s, investors interested in penetrating markets or utilising cheap labour could find inexpensive capacity expansion opportunities through privatisation in other transition economies, such as the Czech Republic, Poland and Slovakia. The fluctuation of privatisation revenues in the four countries shows a close similarity with fluctuations in FDI inflows. This indicates that privatisation was the main driving force of FDI in central European transition economies. Privatisation supply is exhausted in the mentioned other three countries as well, especially in manufacturing. Therefore, one of the main factors for transition to market economic structures, i.e. privatisation, is over now.

During the past 10 years, both market and efficiency-seeking investors could find plenty of opportunities to invest in Central Europe. They actually did so, and are now present with a sufficient degree of activity. The investment market saturated in Hungary and new investors could not endlessly invest in the region. Worldwide concentration process on various markets decimates market players, thus limiting the number of potential investors. It is therefore very likely that further expansion and investment can be expected, mainly from investors already present in the markets of Central Europe. Also, mergers and acquisitions (M&As) will play an increasing role. A number of major acquisition deals were conducted in Hungary among private firms (not to mistake them with privatisation deals, which are, in a sense, also acquisitions!). M&A used to be the major driving force of the worldwide skyrocketing FDI during the second half of 1990s, and they dropped back the most after the great setback of global FDI flows in 2002. Comparing the decline in global FDI flows by twothirds, the stagnating FDI level of transition economies is a fairly good performance.

Market saturation was also coupled with an increase of labour costs. Between 1992 and 1998, real wages increased slower than productivity (in some years even declined), thus decreasing unit labour costs. Between 1998 and 2000, the level practically stagnated. Between 2000 and 2002, there were several government measures aimed at increasing salaries and minimum wages. The result was an approximately 30 percent increase in real wages, while productivity went up by only 10 percent. Consequently, it led to an increase in unit labour cost.

In the same period, competing with Hungary for FDI, other transition economies showed a decline in unit labor costs. Hungarian wage costs were higher by as much as 40 percent as compared with other neighbouring countries, especially taking into account the effect of the continuous real appreciation of the local currency. The negative effects of this development not only affected labour intensive industries and tourism the most, but also those capital-intensive efficiency-seeking investment which intended to utilise cheap unskilled labour. Their margins disappeared as well. Increasing unit labour costs deteriorated the overall competitive position of the country, not just labour intensive activities.

Another important attraction factor was the fiscal and regulatory incentives. The long tax holidays of corporate income tax were important tools because they effectively created a tax haven in Hungary. Its value can be really appreciated in global dimensions. Profits of global activity can be channeled to low tax locations. This was especially important in case investors planned to carry out further investment and invested profits generated elsewhere in Hungary.

Another important tool was the establishment of industrial free-trade zones. These zones provided customs and tax exemption not only for operational purchases, but also for fixed assets and investment, which was an important long-term cost benefit. Both incentives have been heavily criticised by the EU in the accession negotiations. They were withdrawn and presently no other powerful incentive mechanism is in place instead.

As a result, a completely new investment situation evolved in Hungary, with the decline in FDI inflows. The inflow of FDI will increase again if the Hungarian economy can provide the necessary conditions for more sophisticated economic activities. The creation of these conditions should be the primary goal of economic policy in future.

CHAPTER-3

Capital Flows Connected to FDI

Much of social costs of transition were borne by the central budget that ran a substantial primary deficit until late 1990s. The deficit was partly financed through privatisation revenues, and thus from FDI, which also helped the Balance of Payments (BoP). However, this situation also changed. Firstly, because the acute budget deficit problems were brought under control (though they re-emerged in 2002-3). Secondly, because net FDI inflow dried up. The BoP aspect remains important because various capital and income flows gained importance during the past few years. Three major flows need to be discussed. The first is profit repatriation, the second is cost and loan transfers and the third is outward FDI.

Owners of capital have the unlimited right of free disposal of their (taxed) profits. This is a basic rule of a market economy, a fundamental of property rights. This rule should be applied equally to domestic and foreign capital. Equal treatment is also an important market economic principle that should also be applied for the right of profit disposal. Therefore, limiting of foreign capital owners in their right to transfer their earnings is a violation of basic market economic principles. Such actions are regarded as prohibitive for future investment; their impact is similar to nationalisation. It is, of course, an important task to promote reinvestment of profits in Hungary.

The current tax system is in fact very efficient from this viewpoint. Till now, major repatriations of profits occurred only in case some (mainly institutional) investors wanted to finance through these profits deficits produced elsewhere in their global portfolio. The process is rather diverse: Hungarian tax regulation attracts profits from abroad. Nevertheless, it is a fact that from late 1990s, substantial amounts of profits have been transferred from Hungary abroad. The main interpretation of this is positively implying that the earlier investment worked efficiently and generated sufficient earnings.

TNCs are often blamed for using transfer pricing and other tools to eliminate profits, or to transfer profits from one location to another. Inter-company loans, business services and royalties are usually based on actual performance. However, the price is set administratively, and in many cases there is no sufficient control or a suitable market price to compare with. The prices are set arbitrarily according to the needs of capital and income transfers. It may be inconvenient for local governments, which do not have proper knowledge on economic events, capital flows, and corporate behaviour. Economic policy making becomes difficult if reactions of firms on government policy measures cannot be foreseen. This type of increasing uncertainty is a feature of globalisation, and the mobility of firms and business.

It is believed that much of (hidden) business transactions that are carried out with the use of uncontrolled cost and loan schemes have a very wide range of business rationale, only one of which is profit repatriation for tax evasion. Speculation seems much more important. It is a fact that speculative capital flows are sometimes larger than profit transfers, and are therefore dangerous. Such speculative tricks are less likely in the case of FDI, since fixed assets are by definition much less flexible and convertible. Hungary is a good example of the false suspicion of profit transfers behind cost and loan transactions. There have been significant fluctuations in these transfers during the past five years, despite the relative stability of the tax regime, the exchange rate and the Hungarian economy as a whole. The rationale for the movement of capital is the financial requirement of the whole global corporate network.

Outward FDI from Hungary also has a negative effect on the BoP. Outward FDI is, however, usually treated as a positive feature of the Hungarian economy. Hungarian-based firms' international expansion is very much in line with all major political concepts, and is in fact also necessary from the business point of view. There is some discussion among analysts about the real origin of the Hungarian "transnationals". Are major investors like the oil company MOL, the telecom company MATÁV or the savings bank OTP, Hungarian firms, or affiliates of other TNCs? The fact is that there is foreign ownership in all three firms. There are also a few manufacturing companies having affiliates abroad.

The question is important from several aspects. One is economic policy: analysts believe that "true Hungarian" firms are more likely to positively respond to policies, than the others. Another aspect is the origin of the capital invested abroad. If Hungarian firms invest, it is likely that they may use money mainly raised in Hungary (but not necessarily). Foreign affiliates, on the other hand, are likely to use money stemming from the parent company. They do not retract money from local (Hungarian) investment. On the other hand, even if it is Hungarian money that is invested abroad, such international expansion resulting in formation of a TNC is perhaps the most important and unavoidable element of these firms' competitive strategy. They must grow in size to match the challenges of bigger firms, otherwise they may be crowded out even from their domestic markets.

Changes in actual capital flows show a change in the investment environment in Hungary. There are a number of cases of closures and failed investment projects that provide useful information on what has changed in Hungary. The most important closures of the past year were IBM, Flextronics and Marc Shoe, which moved to China. The two failed investment projects were registered in the automotive sector: VW settled in eastern Germany, Peugeot in Slovakia, instead of Hungary. A careful analysis of these cases highlights the main reasons, the size and nature of the problems. Three factors are discussed: shift in locational advantages, insufficient supply of crucial production inputs and deteriorating country image.

There is a recent trend of closing down facilities in electronics, textiles and apparel industries. Mexico experienced a similar wave last year. The firms moved from Mexico to China, just like from Hungary. The activities that were divested were based on the temporary use of cheap unskilled labour: the utilisation and duration of investment depended on this single factor of production. These are special types of efficiency seeking investments. There is no sign of other types of investment massively leaving Hungary or Mexico.

Both, the steady increase of unit labour costs, described above, and the emergence of China as the new low cost investment location triggered this shift in the Hungarian case. This move should not be regarded as a failure from either side. Investors did not intend to stay in the long run. This is rather obvious: they did not develop local supplier roots. Their activities in Hungary were brief, but mutually beneficial. Hungary enjoyed employment of several thousand unskilled employees, a major relief in times of high unemployment. Also, investors contributed as net taxpayers to the central budget, despite the tax allowances that they enjoyed.

It was also not a real failure that the Hungarian Government could not increase such investment into the local economy, or maintain them for longer periods. All this was not planned in the original investment calculations, and was against it (loosing flexibility by accumulating sunken costs). To some extent there was a kind of spillover; at least employees learned from this experience. The movement of these investors from Hungary was predictable. The end of the transition period as well as the approaching EU membership both implied an increase in real wages: bad news for labour intensive activities. The opening up of large low cost countries in Asia also suggested a shift of these activities to other locations. In some way this may also be regarded as a first step in upgrading FDI capacities in Hungary. The next step would be an increase in the stock of investment employing skilled labour. Hungary still possesses substantial reserves in unskilled labour, employment or training of which remains a difficult task.

It was also a rather shocking experience for Hungarians, when in the face of the shrinking demand for investment opportunities in Central Europe, investors preferred locations other than Hungary. In fact, Hungary has not attracted any new large-scale investment projects during the last 5 years. Even the non privatisation-related greenfield investment were carried out elsewhere. The absence of long-term investment during this period cannot be explained with changes in short-term conditions. Changes in cost structure or exchange rate problems are not sufficient reasons. Long-term competitiveness in capital attraction also weakened.

One element of this was the drying up of the supply of qualified labour force in the most important FDI locations. Imported labour from Slovakia could not be a long-term solution, since it could be better employed in Slovakia: Peugeot made the necessary investment there. The potential ways of lifting this bottleneck failed. Migration in the country did not increase, the training of the unskilled did not bring quick results, and the development of infrastructure (mainly highways) was slow and did not connect further labour pools to the FDI heartland of Hungary.

Another disappointing experience that proved to be significant was a lack of competitive local supplier companies. Firms with a sizeable, experienced and strong domestic production background are valuable national assets. Because of various reasons, this middle class of Hungarian enterprises disappeared in the transition process. Local business is still weak and inexperienced. Many times their technical capabilities do not match with advanced large-scale production requirements. Their financial position is usually also weak. All these deficiencies mean an increased risk for transnationals. It is there fore not surprising that development of local linkages was troublesome and the process was slow even in those cases where local content rules forced foreign investors to promote linkages. The existence of appropriate supplier networks in the automotive sector of Slovakia might have had an influence on Peugeot's decision to move there. Their companies gathered sufficient cooperation experience with VW.

The third problem is the image of Hungary that has deteriorated during the past few years. Hungary enjoyed a very favourable image during 1990s as being a forerunner and pioneer of the transition process in Central Europe. This image was linked to the systemic change, and after accomplishing it, there remained little to attract international interest. Other countries could link their country image to important products or services, to a “lead product” that received worldwide reputation. Hungary did not have such lead products. On the contrary, the economic structure changed in the direction of component production. The country image lost focus. The image deteriorated further as the Hungarian Government paid little attention to existing investors and concentrated on attracting new investments. This affected investors negatively, and through their dissatisfaction the new would-be investors received discouraging signals from Hungary. This organic policy problem was also coupled with anti-FDI rhetoric during the last election campaign, which upset many investors. The long lasting accession debate with EU over the retrospective withdrawal of already granted tax allowances also discouraged investors, and questioned the image of Hungary as being a secure supporter of international investment.

CHAPTER-4

Stakeholders' Views on FDI

Hungary's success in capital attraction was based on both the generous incentive system, and FDI-oriented privatisation policy. FDI became more or less an autonomous process when these policies accumulated a certain threshold level of investment in the country. The first-comers invested in a highly uncertain environment, and thus they required extra returns on their investment. Later on, as information and experience was gathered, investment became less risky, normal business opportunities became more evident, and special opportunities and benefits were reduced. The first message is, therefore, the importance of information and experience generation. The first-comers need to be rewarded for their decisions.

The small market quickly absorbed huge amount of investment and became, in a sense, saturated. This meant that without new opportunities the flow of FDI slowed down. Reinvested profits became the primary tools of investment. This was, of course, not a problem in itself: the economy continued to grow and the FDI expanded. But FDI did not play the balancing role in BoP any more.

The first period of the FDI-based modernisation model came to an end and Hungary integrated into the international division of labour at the level that corresponded with the available technical infrastructural and human capabilities of the country. In some aspects, reserves were not fully utilised, e.g. engineering skills and experiences are still available, or the uneven regional spread of investment left similar quality production inputs unattached in many regions of the country. However, it also seems, that given the absorption capacity (saturation) of the country, the increasing competitiveness of neighbours, and other regions, as well as the overall decline in FDI, a fundamental change in the current extent and pattern of FDI cannot be expected in future. The real challenge is therefore opening up new opportunities and creating fundamentals of a new, higher level of integration of the country into the international division of labour.

There are important policy requirements in order to achieve this new status. These should be at the bottom of the national development plan. Unfortunately, currently the national development plan still focuses on issues that largely support the current model. The plan lacks future vision. The increase of

Hungary's role in international labour division requires most of all a regular supply of properly educated and healthy labour pool. The whole education and health system should be reorganised. Its performance has deteriorated over the period of transition, when they were in fact neglected completely. Consequently, the quality and quantity of accessible labour force deteriorated dramatically. The new development stage requires a flexible, creative, and properly trained workforce in information technology and experienced in other sciences. The education system currently produces theoretically oriented and specialised (inflexible) white and blue-collar workers. An adequate level of knowledge of foreign languages is still a problem, though there has been some improvement in this field.

The current tragic situation of public health services is also threatened with collapse, and jeopardises even the health standards of the labour force. The deterioration of health conditions (e.g. the exceptionally high mortality rate of adult males) is a consequence of tough employment conditions. The political turmoil led to crashing of the trade union system in Hungary and there is no effective protection of employees' rights. This resulted in overall deterioration of employment conditions, a continuous overloading of employees by all economic agents: foreign and domestic alike. In fact, weak worker organisations were also an important element of capital attraction. Similar tendencies can be observed in many other countries, but nevertheless, this means a major contribution of declining health conditions. Establishing a stable background of human capital supply is the most important aspect of future development.

It is also important to create national lead products. There were some trials in this direction, but they all failed primarily because of the lack of sufficient (financial) support. Campaigns of publicising Hungarian food products were run in many countries with limited success: the food sector in general was at a great disadvantage due to massive subsidisation practices of the EU. Now, after joining the EU, this situation may change over time, though the EU keeps protecting current producers: for 7 more years there will be no equal treatment of current and new members in relation to agriculture and food production. Still, concerning national endowments, Hungary is poised to be an important and efficient food producer of the EU.

Another area of national strength that could be used as a core of future development is information technology (IT). IT used to be a successful field of science, and also business, in Hungary. It was one of the very few sciences that were successfully promoted by subsequent governments. During the 1980s an important programme was launched to supply even elementary schools with personal computers, later with access to the Internet. Consequently, IT education in the country also resulted in advances in information sciences, and in business applications. IT, especially software development, can be another focus of future development. The rather strong position of IT in education provides for launching a future-oriented overhaul of the education system.

There are a number of problems that need involvement of the government. The attraction capacity of the country needs to be restored. This can be done with innovations in the area of application of new incentive measures instead of the ones that had to be lifted. Hungary has been a fair and reliable partner, and did not want to counter the letter and spirit of agreements. It will, therefore, be difficult to find opportunities to provide extra gains for investors, especially financial ones. On the other hand, the practice of Ireland, for example, shows that the EU tolerated the use of non-conforming attraction tools for some time, and when they were lifted, the new ones were all ready to get introduced. Thus, a flexible innovative incentive structure can still provide important advantages in different areas. Unfortunately, there is no sign of such innovations until now.

Stronger support of domestic entrepreneurs would be also necessary in order to improve the spread of spillover effects of FDI in the country. Local firms have to grow and develop to the size, technological proficiency and financial strength that provides them a chance of steady contact with TNCs. The spread of spillover effects should be also enhanced regionally. An important tool of limiting regional disparities is the development of infrastructure. Highway construction proved its role in attracting investments. Important countryside pools of properly educated labour force could be opened for new investments.

The above policy suggestions require substantial investment that Hungary is not able to raise. The pace of modernisation crucially depends on two factors. The first is national capital accumulation. This function was weak, during the past years, since postponed consumption took much of earnings in case of Hungarian entrepreneurs. Even now, Hungarian entrepreneurs' perspectives for business decisions are not beyond 2-3 years. This is also a result of the existing high level of uncertainty. It is hoped that perspectives improve and uncertainty declines over time. Another potential source of investment is EU funding. EU was rather parsimonious when offering funding for modernisation process for new entrants. The entry of Spain, Portugal, Greece, and Ireland was supported by larger financial transfers than the support the transition economies were due to receive in their process of entry. Nevertheless, little is still more than nothing, and when already in as members, newcomers may bargain much better positions for the next EU budget due in 2007. EU transfers may provide the backbone of the national development project envisaged above.

CHAPTER-5

Agenda for Action - Government

Chapter 2 has outlined the changing capital attraction factors in Hungary. The inflow of FDI will increase again if the Hungarian economy can provide enabling conditions for better economic activities. The creation of these conditions should be the primary goal of economic policy in future. The government, therefore, has the key role to perform.

To start with, the current national development plan should focus on the future requirements rather than the 'old' issues. The privatisation opportunities in the country appear to have reached a saturation level. The difference between increasing labour wages and productivity is now quite large.

It is necessary to create a regular supply of a properly educated and healthy labour pool by reorganising the education and health system. IT-trained labour, white and blue-collar workers, who are less theoretically oriented, and people with adequate knowledge of foreign languages, have to be created. The public health system has to be revamped as it is threatened with collapse due to dissolution of the trade union system with the change in the political system. Emphasis on the IT sector, especially software development, is needed.

Creation of national lead products to improve the image of the country should also involve the government. The image of the country can be further improved by paying more attention to existing investors as their dissatisfaction sends out discouraging signals to the potential ones.

The government should restore FDI attraction capacity by innovations in the area of application of new incentive measures though it would be difficult to provide opportunities, especially financial, to investors. The incentives being provided in the industrial free-trade zones have been withdrawn and no other powerful incentive has been put in place.

Stronger support of domestic entrepreneurs would be necessary in order to improve the spread of spillover effects of FDI in the country. Measures are needed to ensure that the local firms grow and develop to the size, technological proficiency and financial strength that provides them an opportunity of maintaining steady contact with TNCs.

CHAPTER-6

Agenda for Action - Civil Society

An important feature of transition economies in Central Europe is their mistrust and hesitation concerning civil society organisations (CSOs). This is the result of the many decades long misuse of the predecessors of such CSOs by the communist governments. Such organisations did not function autonomously but were changed into the political leaderships' tool to influence the masses to participate in politically motivated programmes. Since CSOs did not organise themselves on a fully voluntary and politically independent way, they were among the first political organisations that dissolved after the transition. The dubious heritage of the movement, the current developments and the fact that many of the successors of such organisations (and many newly founded organisations alike) got under the influence of radical political movements and parties effectively blocked the substantial increase of CSOs' influence in the society.

This is despite the fact that many negative features of current "newly established capitalism" are felt in the country. Unfortunately, the weakness of Hungarian CSOs coincided with the worldwide weakening of CSO movements. From the Hungarian angle, the collapse of the West-European welfare system is especially disturbing. The benchmark point, the European Union, is in crisis, and this crisis does not send a promising message for Hungarian CSOs. People still have much to lose, much to risk, and the "newly established capitalism" also provides acceptable welfare for many people, at least when compared with the era of the communist regime. The balance of gains and losses, of chances and risks, is still positive.

The recommendations of the IFD project for Hungarian CSOs, as well as for Hungarian participation in inter-governmental organisations (IGOs) which can be characterised by and large the same way as CSOs, must emphasise that an effective representation of interests depends on their ability to regain mass support from the society. It is unlikely that this is possible using the tools and methods that were discredited by the previous political regime. Marches and mass demonstrations, and shouting of slogans are not the right tools now. It is true, on the other hand, that less provocative means get little attention, since the society is still in an euphoric mood enjoying the long missed experience of mass consumption. The negative signals of the process, especially the long-term risks, are all too far and seem unimportant now.

The first and most important issue for CSOs would therefore be to establish themselves as reputable organisations both in the eyes of the society, and the government. The following issues and tasks should be stressed:

1. Establish the links between business, education, earnings and higher purchasing power. The essence for future development is investment in human infrastructure with the help of business. Better-trained employees generate more value that can be shared by labour, capital and the government. This means increased tax revenues and profits (to cover costs of education), as well as increased consumption and demand for business (opportunity to expand sales).
2. Call attention for sustainable development. Consumption in Hungary is catching up with the EU patterns now. It must be stressed that Hungary cannot achieve the same level within a short period of time without risking the background conditions of development (environment, health, etc.). What is common in the EU now is the result of balanced development of several decades. Hungarians should not try to make efforts at dramatically shortening the time demand of the catch-up process. Large TNCs also have responsibility for this, since their prime interest is pushing up sales regardless of the costs. Effective means of consumption control, as well as a much-missed increase in savings and capital accumulation should be achieved. Most effective tools of this are in the hands of economic policy, but CSOs may also play an intensive role in shaping public opinion and supporting government incentives.
3. It is exclusively CSOs' task to educate consumers to separate the valuable from the worthless. In this current euphoric wave of consumption everything floats in the markets, and without the basic ability of consumers to evaluate products they often make wrong decisions. The choices are many times suboptimal because of poor technical parameters of the products. This problem may ease with the introduction of EU quality standards. A more serious problem is with the consumption that encompasses moral hazards. Consumers' education about learning advantages and disadvantages of uniformity and diversity in consumption is important.
4. CSOs may urge government to strengthen regulations in a number of areas. The very loose regulation of commercial messages, inefficient control of competition, harmful patterns in employment policy of firms, are perhaps the most important areas of legal regulation, where CSOs may want to press government for reconsideration.

CHAPTER-7

Agenda for Action - IGOs

Hungary's international position is not very favorable from the viewpoint of cooperation from IGOs either. The accession to the EU largely determined the room for maneuvering. Hungary, as a fairly small country, could not even rely on the size of her market when negotiating the entry conditions of the country, unlike Poland. Today, when most negative consequences of joining the EU have already started to bite, it is very important to become an integrated part of the Union as soon as possible, in order to start enjoying the benefits as well. Therefore, Hungarian position vis-à-vis IGOs is basically determined by policies pursued by the EU. The picture may be very different, whenever Hungary becomes a full-ratified member, hopefully this year. The basic parameters will still be by the main EU positions, but Hungary may take part in shaping these conditions. It is too early to evaluate future ties and freedom since the complete EU administration is under reform now, including the basic institutions.

Thus, the basic area of Hungarian international activity will be the EU. Within this framework, Hungary may increase its influence in cooperation with other members. A current conflict in the EU between France/Germany on the one hand, and Spain/Poland on the other clearly indicated the stake of the current reforms of the EU: monopoly of decision-making in the hands of few big members (with many common interests), or a more democratic (maybe more inefficient?) structure, with better chances for representing small countries' interests. An important tool in this process could be the cooperation among the new joining countries of Central Europe. The framework of the cooperation already exists, though it was not used very efficiently in the past (e.g. not in the negotiation process before joining the EU).

CHAPTER–8

Conclusion

Hungary was regarded as one of the most successful economies in transition in Central Europe. The process involved economic restructuring and modernisation in which FDI played a decisive role. The FDI inflows were facilitated at that time on account of Hungary's advantageous location, a sufficiently developed infrastructure network and cheap labour force.

However, at the turn of the century, important changes in investment trends were noticed with declining FDI inflows, services and trade taking precedence over manufacturing, market saturation coupled with increased labour costs, geographical relocation of foreign investors, increasing FDI outflows etc.

FDI inflows can increase again in Hungary if it can provide investors with the necessary conditions for more sophisticated economic activities. The challenge is to open up new opportunities and create fundamentals of higher integration of the country into the international division of labour. Important policy initiatives are required to achieve this by ensuring a regular supply of a flexible, creative and trained workforce.

The education system needs to be revamped with adequate IT inputs and knowledge of foreign languages. Public health services also need to be addressed to control high mortality rate in adult males.

It is also important to create national lead products. The food sector offers good potential. Innovations would be required in the application of new incentive measures to provide advantages in different areas.

Stronger support of domestic entrepreneurs would be required to improve the spread of spillover effects of FDI in the country. It would be necessary for the government to involve the civil society and the IGOs for increasing FDI inflows.

ANNEXURE

Summary of NRG Discussions

One of the most important activities of the IFD project was the formulation of a National Reference Group (NRG) in each project country to provide a sounding board and quality check on the research outputs. The main purpose of the NRG meetings was to attract attention to the project at the national level.

First NRG Meeting

January 29, 2001, Budapest

Participants were sent a shortened Hungarian version of report A as an introduction to the discussion of the meeting.

There was a general consensus of approval of the contents of Report A, with some modifications. The participants pointed out that the differentiation between privatisation and greenfield FDI inflows was simplistic.

The participants agreed that a new epoch had started in Hungary as far as FDI was concerned, marked by a qualitative change in the structure of investments. Some disinvestment were experienced in the country when labour intensive activities moved to other locations with cheaper labour resources.

There was a general agreement that the qualitative change in the FDI stock could be promoted by the government. The development of the production inputs that are required should be improved, particularly an educated and creative labour force. The government should address the issue of a sound labour policy. Thus, the major field of state intervention should be education and health. In order to tap positive spillovers from FDI, Hungarian firms (suppliers) have to modernise. It was also recommended to broadbase FDI inflows and avoid dependence on a single transnational company. This kind of dependence may be dangerous in periods of recession, when cutting back of activities usually starts with outsourced supplies.

Second NRG Meeting

September 12, 2002, Budapest

It was discussed whether state economic functions could be taken over by private (foreign) business. Obviously, there is only limited overlap of the state's economic tasks and what foreign business can and is willing to do in order to fulfil national development targets. Thus, a reconsideration of state roles seems to be unavoidable.

The next issue that was examined was how effective could the foreign companies be in delivering modernisation effects to the Hungarian economy. Many of the direct effects seem to bring both good and bad results. For example, increased competition forced many Hungarian companies to restructure activities, but many could not cope with the challenge and exited the markets. Concerning indirect effects, the picture is even more scattered. It was felt that foreign firms' indirect spillover effects may affect Hungarian companies only if there is an intensive link between donors and recipients, be it a competitor status, or strategic partnership. If firms do not meet on markets, there is no interface for the to transfer spillover effects.

Thus, the limited scope of spillovers experienced until recently raises the question if the current strong duality of the country can be limited in future? The answer was ultimately yes. An analysis of foreign investors proved, that in terms of employment, number of business entities or invested capital, a relatively small group of foreign firms belonged to strictly regulated international corporate production networks, that seem to be not contestable for Hungarian suppliers. The overwhelming majority of foreign firms can incorporate domestic deliveries and may develop local linkages. It is a primary task of the economic policy to enhance the linkage development. The first attempts in this direction did not bring a breakthrough.

It was pointed out that despite the withdrawal of the state from the economy, the level of state sector employment (bureaucracy) did not change. The declining performance and maintained flow of wages meant deterioration of efficiency of the bureaucracy, which negatively affected the country's international competitiveness. There were at least 30 transnational companies worldwide whose sales turnover was more than the GDP of Hungary. This meant that the Hungarian government could not influence investment decisions of these firms.

Positive results of FDI were also discussed, such as improvements in production structure, quick development of the telecommunication system and the end of strong geopolitical dependence on the East. But the strong positions of foreign firms caused many difficulties for small business, because the foreign management decided on important corporate decisions, neglecting the interests of Hungarian ventures. They are also at a more advantageous position, because they are better capitalised and have more access to outside finance as well. Further, the Hungarian government subsidised foreign investments against Hungarian ventures. This practice undermined the not too favourable competitive position of domestic ventures.

It was also stressed that investment motivation is always based on business calculations. Investors search for high capital return opportunities at low risk level. There are a number of valuable assets that can be used to increase the return on investment. For Hungary it is the relatively cheap, productive skilled labour.

The Hungarian FDI policy should be targeted at attacking global investments by offering a variety of valuable assets for key strategic functions. It is important to locate investments on the "source side" of the international business, and not to the "sales side", thus contributing to income and added value generation, rather than spending the income for products and services obtained from outside of the country. Some participants felt that FDI was especially useful from two aspects. It limited the previous strong one-sided dependence of the Hungarian economy and replaced it with a more diversified international cooperation network. A second important benefit was the transfer of important technical and managerial knowledge.

It was emphasised that a change in the nature of FDI policy is required. It must be adjusted to the current needs of the country, as well as to the requirements of the EU.

Third NRG Meeting

April 29, 2003, Budapest

The introduction of Report C highlighted the fact that FDI in Hungary declined in 2002, and this change had long-term implications. On the one hand, security of global business was weakened both in the economic and in the political sense, and on the other, a strong decline observed worldwide also affected Hungary. Increasing outward investments outpaced declining inward FDI.

Moreover, the decline of inward FDI was affected by the divestment of two major investors in Hungary. This means what we see is not only less new investments, but also a potential decrease of the FDI stock in the country. The interpretation of this starting new trend was that Hungary's comparative advantage in attracting capital through low cost of labour disappeared. The reasons of this were a 30 percent increase in real wages during the past three years that was not counterbalanced by the increase in productivity (10 percent). Also, the steady appreciation of the national currency made activities more expensive when carried out in Hungary.

Many companies could overcome shortage of skilled labour supply by launching large-scale education and training programmes. This signaled a shift in the interest of investors in employing skilled rather than unskilled labour. However, the declining trend in the flow figures did not necessarily mean a decline in actual investments, since reinvested profits are not included in that figure. Despite generous tax incentives, foreign firms remained net tax payers, since the amount of wage taxes, and local taxes outweighed the forgone income tax.

The main problem of Hungary's international performance was that the country had no lead product in the export market and that there was little positive message about the country. Besides the image and reputation, the lead product could also form the nucleus of a larger production network based in Hungary. The Hungarian lead products were phased out of the markets because of the uncontrolled competition of the EU, especially in the agriculture and food industry. Hungary has a comparative advantage in this area that can not be enjoyed due to EU protectionism.

It was also felt that the current declining trend in FDI was a result of the wrong incentive policies, which concentrated solely on new investments. Policies aimed at maintaining and developing FDI in the country were neglected. The negative signals from operating foreign companies carried out a deterring effect on potential new investors.

Further contributions also stressed the importance of a favourable general business climate identifying it as a crucial element for new FDI and also for the development of co-operation links with local enterprises. The importance of incentives attracting new investments was therefore regarded somewhat less important, than it was considered before. This was a result of the current disappointment caused by shrinking FDI inflows.