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FOREIGN DIRECT INVESTMENT & PRIVATIZATION IN HUNGARY

Strategies of Multinational Enterprises

in the

Early Years of Transition

(1989-1992)

By

Carolyn Conner B.B.A.

**A thesis submitted to the
Faculty of Graduate Studies and Research
in partial fulfilment of
the requirements for the degree of**

**Masters of Arts
Norman Paterson School of International Affairs
Carleton University
Ottawa, Ontario
August 3rd, 1993**

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ABSTRACT

This study analyzes seven major privatization - acquisition cases in Hungary's manufacturing sector to provide conclusions regarding why Multinational Enterprises are investing in the privatization of Hungary's manufacturing sector and to assess the problems inherent in such an investment as well as how those problems are overcome.

In the first half of the study a review of the relevant literature on the Foreign Direct Investment activities of MNEs is provided together with an assessment of the investment environment in Hungary and an overview of the issues relevant to privatization. This sets the ground work for analysis of the case studies in terms of the strategic goal of the Multinational Enterprise and the problems the investor faced.

The conclusions of the case study findings argue that the strategic goals of the Multinational Enterprises investing in Hungarian privatization could be categorized as either market access or production oriented and that market oriented goals were the more prevalent. Further, the findings concluded that the Multinational Enterprise was able to circumvent many of the problems inherent in the investment environment through exploiting its firm specific advantages. The most crucial problem brought out in this study were human resource problems associated with changing people's attitudes and work habits as well as finding market oriented management skills.

ACKNOWLEDGEMENTS

During the two years it has taken me to research and write this thesis, I was fortunate enough to have the assistance and support of many people without which the thesis might never have been finished.

The people at Carleton University, both at NPSIA and at Carleton International, provided me with the challenge and opportunity to do the research and to live in Budapest for an extended time. In particular, I would like to thank Brenda Sutherland for dealing with all of my administrative matters while I was away and my thesis Supervisor and Advisor, Prof. Carl McMillan and Prof Barbara Jenkins.

The members of the International Community in Budapest who both gave me information and support during my stay in Hungary. In particular, George Hollo, Kristin Stolen, and Vanessa Cook who all helped me keep my sanity and keep focused on my research.

Last but not least, my parents and step father - Barbara Conner, Wilfred Conner, and Park Sullivan - whose love and support has always been with me and who have helped me in ways they may not know.

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LIST OF ACRONYMS

MNE:	Multinational Enterprise
SOE:	State Owned Enterprise
FDI:	Foreign Direct Investment
CMEA/	
COMECON:	Economic association of the countries of Eastern Europe and the former Soviet Union.
SPA:	State Property Agency
EWJV:	East West Joint Venture
IPE:	International Political Economy

FOREIGN DIRECT INVESTMENT & PRIVATIZATION IN HUNGARY

Strategies of Multinational Enterprises in The Early Years of Transition (1989-1992)

CHAPTER I. INTRODUCTION

The years 1989 and 1990 marked the end of a period known as the 'cold war'. People in the streets chanted for free democratic elections, civil rights, and an end to the communist centrally planned economic system. Such cries had been heard before with either no, or bloody, results: Budapest 1956, Prague 1968, and Warsaw as recently as 1980. This time was different however. As the world watched the Berlin Wall fell and demonstrations led to the demise of communist governments in East European countries - in particular Czechoslovakia, East Germany, Hungary, and Poland.

Multi-party elections were held. The CMEA¹ was disbanded. The Warsaw pact was dissolved. Germany was reunited. People took advantage of new freedoms of speech and expression. Together with these political and civil reforms came the beginning of a long and painful process of economic reform. As the communist parties lost power the fragile framework which had held the central planning economic system together dissolved. The dramatic political events of 1989 meant not only a need for political reform and free elections, but also demanded reform of an economic system which had led to stagnating economies and poor standards of living.

The question which remained was how to transform these countries into functioning, growing economies which could interact in an increasingly integrated global

---

¹ The term CMEA or COMECON refers to the economic association formed between the former socialist states of Eastern Europe and the former USSR.

market place. How to create a market type economy from a centrally planned one? Communist theory explained the evolution of economic systems to achieve communism, however, since this was to be the last evolutionary step, nothing explained what to do if communism failed. Experiments in 'market socialism' provided some examples of what might possibly work but no past reform efforts were as extensive as the task facing these governments in 1989. The task ahead would involve a great deal of trial and error and doubtless economic pain.

Two of the most radical and controversial parts of the reform efforts were the encouragement of interaction in the global economy through deregulation of Foreign Direct Investment (FDI) and the widespread privatization of the state sector. While FDI had been allowed in the majority of these countries since the 1970s in the form of Joint Ventures, the new reforms would allow for 100% wholly owned subsidiaries and the acquisition of existing State Owned Enterprises (SOEs).

These reforms symbolized the beginning of a new era and the end of the communist economic system. There was no history of such radical reforms on such a mammoth scale to use as examples or models for the development of an effective program. This left the governments of the former socialist countries on their own to develop a model which would be most appropriate to their situation. While the ultimate goal was the same: 'conversion to a market economy', the means proposed to achieve this goal were radically different on the part of each country².

The acquisition of an existing company is generally the FDI option of preference

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² For good reviews of the Hungarian model in comparison to those of Czechoslovakia, Germany and Poland in particular see Gruszecki (1991), Kwasniewski (1991), Leyson (1991), Mizsei (1992), and Pohl (1991).

for MNEs³. In the former socialist countries, since the state is the owner of almost all existing enterprises, privatization created the only opportunity for acquisitions. The Hungarian privatization program has been of particular interest to foreign investors, not only because Hungary was the first, but because of the privatization program's unique nature in focusing on finding strategic investors for the privatization of state assets. Rather than quick privatization of its state sector the Hungarian government adopted a policy of selling its assets. The primary goal was gradual reform and the assurance of continued growth in the economy as well as a fair financial return for state assets. Overall, Hungary has had a more enthusiastic attitude towards FDI than the other reforming nations.

General conclusions regarding the response of foreign investors to the Hungarian program are difficult to make. Hungarians feel that the response has been slow and cautious and have voiced many complaints. Foreign investors cite the fact that Hungary has attracted the greatest portion of investment in the area and claim that the response has been most favourable. Statistics show that at the end of 1991, more than 50% of all Western investment in Eastern Europe has gone into Hungary and over 60% of that has gone to privatization (Hollo, 1992).

The Hungarian policy to sell its assets brought with it many complications not the least of which were difficulties in attracting investment capital, both foreign and domestic. Hungary's domestic economy did not possess sufficient capital resources or managerial experience to allow for strictly domestic privatization particularly of larger

---

³ Reasons for this preference are discussed in much MNE literature but generally stem from issues of cost, timing and control.

SOEs. While the domestic economy was in a good position to deal with the development of smaller entrepreneurial type businesses, the turn around of large manufacturing entities to make them competitive on a global basis required capital and expertise from foreign investors⁴. As a result, foreign investors have been and will continue to be key actors in Hungary's reform programs, particularly in privatization. The problems and frustrations of foreign investors have had a strong influence on the pace and success of reform in Hungary. It is in part as a result of the strong influence that FDI has had in Hungary that the country was selected for study in this research.

Differences between the economies of East Central Europe in terms of economic situations, industrial basis, and policies adopted by the governments make generalizations based on the experiences of one country difficult. However, there are also many similarities between these countries which would make the experience of Hungary valuable to a study of the others. First and foremost, all of these countries are struggling with the difficulties of something never seen before - converting an economy which has been based on the centrally planned economic model for at least 40 years, to a market oriented system. The scope of these reforms, and the environment in which they are taking place, makes the applicability of any experience in the West debatable, except perhaps as an illustration of what the ultimate goal is. This is particularly true in the area of privatization which, even in the West is a relatively new phenomenon.

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⁴ An examination of this inability of the domestic economy to provide adequate capital can be found in the Blue Ribbon Commission Report (1991).

Hungary has had a dramatic advantage over its neighbours in this reform process⁵. Over the past twenty years, Hungary has succeeded in gradually increasing the extent of private sector activities -albeit most often in the form of black or grey markets- while decreasing its trade with the East and increasing ties to the West in the form of both investment and trade⁶. Because of this advantage, Hungary has been able to advance in the reform process more quickly than its neighbours and thus, as occurred in the past, many of the failures and successes of Hungary may be used as examples for consideration in the other countries.

This study examines Foreign Direct Investment in Hungary from the view of the Western MNE. Because of the preference of MNEs towards acquisitions and the unique nature of privatization in the countries of Eastern Europe, particular emphasis is given to acquisitions of SOEs through the privatization program. The study starts with a review of Western literature on the issues of MNEs and Foreign Direct Investment (FDI). The review formulates in detail a thesis regarding the motives or strategic goals of MNEs in their decision to invest in the acquisition of an SOE, and outlines the factors considered by the MNE in the assessment of the investment environment. This is followed by a brief discussion of the issues surrounding privatization and foreign direct investment in Hungary to provide background for the analysis. Finally, the study

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⁵ Analysis of the relative attractiveness of the East European countries have been done by several sources. Two of the more prominent include one by the World Bank, "Issues in Socialist Economy Reform" (1991), and BLOC magazine (April/May, 1990). The conclusions of all of these bring that Hungary is the more attractive, excluding the former East Germany.

⁶ Radical economic reforms in Hungary started as early as 1968 with the inception of the New Economic Mechanism (NEM) and, while there have been numerous setbacks, it is considered to be the closest thing to a market economy in the region (Brigler, 1992: 448).

analyzes the situation in Hungary based on seven selected case studies. This analysis involves an examination of the investment environment along with the strategic goals or motives of the selected MNEs.

A number of books and investment guides have been written exalting the benefits of investment in Eastern Europe and outlining the legislative and investment environments; the purpose of these guides being specifically to encourage investment. Limited literature is available examining in-depth the difficulties associated with investment and acquisitions in these countries and explaining how problems can be overcome by MNEs. On the other side of the equation, there is also an extensive body of literature surrounding the FDI activities of MNEs. Unfortunately, the focus of this MNE literature has tended to be on investments in the First and Third worlds⁷. Due to the closed nature of the socialist economies, very little of this literature is directed to the Second world. The applicability of this literature when considering the Second world and more importantly how relevant is it in today's transforming economies of the Second world remains questionable.

This study attempts to bridge the gap between these two bodies of literature by considering accepted literature and theories on the FDI activities of MNEs with regards to the situation in the newly transforming economies of the Second world. Specifically the study asks the research questions:

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⁷ The terms First, Second, and Third world are generally accepted in reference to a method of categorizing countries based on their economic structure and level of economic development. The First world being the 'Western' developed nations, the Second being the communist or socialist economies, and the Third being developing or undeveloped nations.

Why are MNEs investing in the privatization of Hungary's SOEs despite the difficulties associated with an unstable investment environment and negative legacies of the communist period? What are the problems they face and the issues they consider when making this decision and how are these problems being overcome?

Methodology

An analysis of seven of the largest privatization-acquisition cases which have taken place in Hungary over the period commencing in 1989 and ending in April of 1992 was undertaken in an attempt to find the answers to those questions raised above. This analysis is based on information gained through primary and secondary research performed in Canada and in Hungary. Field research was facilitated through a one year academic exchange program to Hungary organized by Carleton International. This field research allowed for better insight into the cultural and political environment and an opportunity to carry out direct in-depth interviews with active participants.

The availability of accurate and timely information was limited and the constant changes in the legislative, political, and economic environments implied that the basis for any research was a moving target. This was further exacerbated by the fact that even under the stability of the old system useful and accurate information was difficult to obtain. Due to the radical changes occurring at an unprecedented speed in these former socialist countries, any academic research attempts are riddled with many frustrations beyond those which would be found in similar Western nations.

Through the field study a more hands on approach to research was possible and through residing in Budapest and interacting with the business community it was possible to gain a clearer picture of the true business environment. Much information and insight was gained informally through casual conversations and interviews. In total 45 formal interviews took place as part of the research. Those interviewed include; executives of the companies relevant to the case studies, privatization and investment consultants, and prominent figures in related Hungarian government agencies⁸.

While language and cultural difficulties could have inhibited and limited the research, in general this was not a major impediment. The international nature of the research topic meant that the bulk of secondary source information was available in English and the majority of actors in the process spoke fluent English. The few times that this was not the case it was possible to find effective translators at the Budapest University of Economic Sciences who were both fluent in the language and knowledgeable in the subject matter.

Explanation of Important Terms

As is the case in any area of popular study, many of the terms used as the basis for this study have been used so frequently that often their meaning may become unclear. The purpose of this section is to provide a working definition of the most crucial terms used in this study thus setting the groundwork for the analysis. These terms include: Privatization; Foreign Direct Investment; Acquisition; Multinational Enterprise; Strategic

---

⁸ See Appendix A for a detailed list of the people interviewed.

Goal; and Strategic Investor.

Privatization

For the purposes of this study a definition by Milanovic used in his discussion of privatization in Eastern Europe is the most appropriate.

... the transfer of ownership from the public to the private sector such that the ultimate owners of assets are identifiable physical persons (1991).

In this definition Milanovic covers two key concepts which are crucial to understanding privatization as it applies to this situation. First is the transfer of ownership from the public sector to the private sector. The second is that the new ownership can be tied directly to some identifiable physical persons. Such a person may simply be a shareholder in a company which acquires the state owned enterprise. The key to this is that there does exist someone who has real ownership rights.

Milanovic's definition is quite similar to the definition used by the Deputy General Manager of the Hungarian agency responsible for privatization who stated in a speech given to the Eastern European Regional Conference in June 1992 that:

"Privatization is the release of property from state control accompanied by a real change in proprietorship" (Tarkany Szucs, 1992).

This definition points out that there must be a true change in ownership and control of the assets. This concept has been one of the most crucial in Hungary's program which has focused on a true change of ownership rather than distribution of shares⁹.

One key point brought out in these definitions is a distinction between

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⁹ Other definitions considered include; Kornai (1991: 277), Hunya (1991:1); and that of the Hungarian government agency responsible for privatization.

privatization and '*denationalization*' in the context of Eastern Europe. Denationalization is defined as the removal of assets from state ownership and control. Without the existence of a functioning market for the 'sale' of such assets and with such options for privatization as institutional ownership and wide spread distribution of ownership to the people, assets may be denationalized but not truly privatized in the sense that assets are transferred to a specific private entity.

Foreign Direct Investment

Foreign Direct Investment is defined as an equity investment, involving some form of control, by a foreign entity. This may take the form of either the establishment of a new wholly-owned foreign subsidiary, the establishment of a joint venture with a foreign partner, or the acquisition of a controlling interest in an existing foreign company.

Acquisition

For the purposes of this research, it is the acquisition option which is most important as the subject of study is the acquisition of a former SOEs by MNEs. The distinction between the FDI options may be relatively clear in the Western context but with the situation in the former socialist countries the definitions can become fuzzy and thus require some explanation.

Until the reforms of the late 1980s the only FDI option available in Hungary, or any other former socialist country, was the joint venture. That is to say that any venture

with foreign investment was called a joint venture regardless of whether or not it fit the definition. A joint venture was officially defined as: a contractual arrangement between two enterprises, one foreign and one national, under which a new identifiable business entity is created and the two parties agree to pool their resources to jointly manage operations and share associated risks (McMillan, St. Charles, 1974:1). These ventures often did not in fact involve the creation of a new entrepreneurial economic entity as would be assumed in the West. Instead they were in essence a transformation, involving a capital increase, of either a whole or part of an existing entity. The Hungarian partner (generally the state) brought into the joint venture facilities and equipment from an existing entity while the foreign partner provided expertise and capital.

In the early stages, foreign ownership in such ventures was limited to 49% with the Hungarian partner maintaining official control. Such early ventures did fit the definition of a joint venture since, by requirement, control was shared between the two partners. However, as legislation in the late 1980s allowed for the greater than 50% foreign ownership the clear distinction of such investments as a joint venture became fuzzy. Is an agreement between an outside partner and the owner of what had been a functioning economic entity truly a joint venture if the outside partner holds more than 50% ownership and is in effective control, or is it in essence an acquisition by the outside partner?

It was not until the enactment of legislation governing the formation of new private companies and the privatization of State Enterprises that the creation of new wholly owned subsidiaries and the official acquisition of existing companies was allowed.

There also existed the situation of existing joint ventures where the foreign partner had had effective control in the past, as in the situation described above, and had subsequently increased their share of the ownership of the company to gain official as well as effective control. Are such cases to be considered joint ventures or acquisitions?

For the purposes of this study, the definition of an acquisition is any situation where a foreign investor holds control, effective or official, over what was once either a significant part of or a whole existing economic entity.

Multinational Enterprise

The Multinational Enterprise is defined for this research as any enterprise or company which owns controls and manages production activities in more than one country (Eden, 1992: G3) and which functions under a global integrated philosophy or strategy (Daniels & Radebaugh, 1989).

Strategic goal

This term is used in this research to define the primary motivator or objective of the MNE in making the international investment or acquisition decisions. This goal would be in part influenced by the MNE's global international strategy and it answers the question of what does the MNE want to get out of the investment. What is the objective or goal?

Strategic Investor

A strategic investor is an investor whose purpose or goal is part of an overall strategy and not for portfolio type¹⁰ investment purposes. This investor is generally in for the long term and the investment plays a crucial role in the overall global strategy of the investor.

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¹⁰ **Portfolio investment, unlike direct investment does not involve any control over the management of the company and has remained restricted in Hungary.**

CHAPTER II. LITERATURE REVIEW

This chapter provides a review of existing literature dealing with Multinational Enterprises and their Foreign Direct Investment activities. A review the relevant literature provides conclusions of predictions regarding the strategic goal of the MNE and the country specific factors which affect the investment decision thus making up the investment environment.

The multinational enterprise and its foreign investment related activities have been the subject of much academic research particularly since the 1960 hey-day of American international expansion. As the importance of the MNE has grown so have the number of issues and theories trying to explain and predict its actions. In the globalizing economy of the 1990s the MNE has become the primary instrument for internationalizing both markets and industries. An understanding of the factors affecting the MNE's actions and their effects has become crucial in many areas of study including: *International Political Economy*, *International Economics*, and *International Management*¹¹.

In her article "Bringing the firm back in: Multinationals in IPE" (1991), Lorraine Eden provides a survey of what she considers to be the traditional MNE literature in the area of International Political Economy. Her survey describes the five faces or images of the MNE which include: the Product Life Cycle (PLC); Sovereignty at Bay; the Law of Uneven Development; the Obsolescing Bargain; and the Changing

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¹¹ There exists a relatively restricted body of literature directed specifically at the acquisition decision, however, it has tended to focus more on the logistics of negotiating the acquisition. The more general discussions regarding strategic goals and factors influencing the acquisition decision have remained under the domain of general FDI related literature.

International Division of Labour. Of these five faces, only three have a direct relevance to this research (PLC, International Division of Labour, and Bargaining theory). The other two deal specifically with the effect of FDI on host government which is beyond the scope of this research.

In the area of International Economic literature, the primary focus has been on explaining why FDI takes place and why MNEs are able to benefit from such activities. One of the most extensive reviews of such literature was carried out by Corley in 1986 and 1989¹². In his review, Corley provides an overview of the development of International Economic literature on the subject of MNEs and FDI with particular emphasis on Dunning's eclectic paradigm. Dunning attempts to integrate all of the theories developed to explain the FDI behaviour of MNEs into one framework or model. That framework has formed the basis for most International Economic research.

International management literature tends to focus primarily on the management of the international or multinational company. The majority of literature deals with such issues as: the global competitive strategy, global industries; the international business environment; and choice of entry mode for international expansion. Some of the more prominent authors which have addressed the issues in this paper include: Porter (International Value Chain and the Competitiveness of Nations); Johnson (Incremental Internationalism); Kogut (effects of National Culture); and Daniels & Radebaugh (International Business Environment).

What follows is a brief overview of the above theories which are most relevant

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¹² For reviews of the MNE literature see Buckley (1981, & 1983), Calvet (1981), Caves (1982), Dunning (1981), Rugman (1982), and in particular Corley (1986 & 1989).

to this study including: the *Product Life Cycle*; the *International Division of Labour*; the *Bargaining Theory*; the *Eclectic Paradigm* including advances in the *Internalization Theory*; the *International Value Chain*; *Competitiveness of Nations*; *Incremental Internationalism*; and the *International Business Environment* which includes research on the subject of *National Culture*.

Some of the newly developing theories or theses specifically directed towards the investment decision in Eastern Europe follow this survey of the Western literature in an attempt to shed some light on the applicability of that literature to the situation in Hungary. Based on these two reviews (the Western literature and the Eastern theories) some tentative conclusions are reached in order to both develop a thesis regarding the strategic goals of investors and create a framework for an assessment of the investment environment.

Product Life Cycle

The Product Life Cycle originally developed by Vernon in 1966, explains the rise of multinationals based on the different stages of a 'life cycle' each product goes through. It combines the views regarding the maturing of products with the evolution of an MNE's international production to explain the patterns of trade and investment in both developed and developing countries (Porter, 1986: 57).

The theory asserts that, as products enter the mature state and production becomes more capital intensive, economies of scale are achieved through mass production of standardized products. Firms then expand internationally to take advantage of new,

unsaturated markets. As technology matures and foreign demand increases firms also find it profitable to establish branch plants to supply foreign demand. Profits from overseas production may then be used to generate new products (Eden, 1991 citation from Vernon). In terms of financial analysis the model states that:

a firm should invest abroad when: $\text{Marginal cost of production of the exported good} + \text{the transportation cost} > \text{average cost of production abroad}$ (Buckley, 1989: 78).

After the development of the model, Vernon carried out further research and in his 1977 work he predicted that the primary motive for FDI was the MNE's attempts to protect its market share through the creation of entry barriers in foreign markets. He argued that MNEs, as oligopolies, use their economies of scale in production, marketing, and R&D to keep new entries out. He also advocated what is termed the *bunching principle* where, for competitive purposes, if one MNE enters a given market others in the industry will soon follow. This intense competition ultimately leads to a need for cost competitiveness and induces MNEs to seek out lowest cost production locations from which the MNE will export products back to the home market (Vernon, 1977: 89-102).

In 1979 Vernon assessed the applicability of the model to the changing international environment particularly taking into account the increasing globalization of industries and markets as MNEs established international subsidiary networks. He concluded that: while the model has lost some of its value it remains valid in some situations such as small companies and the development of new products where the time-frame is much shorter but the steps remain. In the words of Lorraine Eden:

the model is still used to point out the essential market seeking character of foreign direct investment (Eden, 1991)

This makes the theory of particular interest to this research. While the overall value of the model in explaining the timing and form of multinational expansion in today's globalizing industries may be questionable, the model does provide some valid insight into the basic goals of MNEs in their expansion. These basic goals are not strongly affected by the globalization of industries and it could be argued that globalization enhances them. The model would predict that the goals of the MNE are either market seeking (as Eden pointed out) or in search for more efficient, low cost production. Conclusions made by Vernon regarding the applicability of the model might suggest that the market seeking goal has become stronger as the technological gap between nations is shrinking and production becomes less labour intensive (Vernon, 1979).

Division of Labour

Hymer's international division of labour uses an extension of Fordism to explain international production patterns. Fordism's basic principle is that the division of production activities into specialized skills can increase production efficiency. International trade theorists have adopted this concept to explain international trade as a specialization of skills amongst nations thus increasing production efficiency on a global scale, 'the law of comparative advantage'. Hymer further extended this principle to explain international production and foreign direct investment.

Hymer's argument is based on the concept of there being two kinds of division of labour:

- a) the division of labour between firms coordinated by the markets; and
- b) the division of labour within firms coordinated by entrepreneurs (Hymer, 1979: 441).

While the first explains international trade, it is the second which Hymer uses to explain the behaviour of MNEs. MNEs ,through their role as a "substitute for the market", reap benefits from the second division. The MNE can earn extra rents from an international division of labour. Through its ability to locate various stages of production internationally, it can take advantage of each country's comparative advantages.

This theory formed the basis of much research carried out by Casson regarding locational advantages as an explanation for FDI. Using a combination of trade theory and Hymer's international division of labour, Casson concluded that: Whereas Ricardian theory would predict that substitution is the primary deciding factor for FDI, in fact factor substitution has a very limited role (Buckley, 1989: 78). He argued that:

The division of labour can... create a pyramid of activities in which both horizontal and vertical specialization occurs. ...The resulting increased specialization enables cost reductions in economies of scale, lower input costs, and transport costs (Casson, cited in Buckley, 1989: 77-78).

Casson also outlined other benefits which the MNE can reap through its ability to create important entry barriers based on proprietary technology and access to knowledge. The MNE creates an opportunity for monopoly or oligopoly rents through the creation of these entry barriers (Casson, cited in Buckley, 1989: 77-78).

In conclusion, the combination of Hymer's pioneering work and Casson's expansion of that work would predict that the MNE expands internationally to:

- take advantage of production efficiencies based on country specific advantages;
- to decrease competition through the creation of entry barriers based on knowledge and technology.

Bargaining Theory

The primary focus of bargaining theory is negotiations between the MNE and the host government. In so far as it discusses the sources of power of each party, the theory can provide some insight into the strategic goal of the MNE as well as the factors making up the investment environment.

The literature in this area is extensive and its ability to explain the outcome of negotiations or predict the changes in MNE - host government relations over time has been debated¹³. The theory argues that the outcome of negotiations between the MNE and the host government is a function of:

- the goals of each party - what each hopes to gain from the investment;
- the sources of power of each party; and
- the constraints on each parties actions.

Of particular relevance to this research are discussions of the sources of host government power and of the goals of the MNE. The sources of government power provide an indication of the factors affecting the investment decision and include:

- a large and growing domestic market;
- valuable natural resources;
- a high level of competition among MNEs; and
- a highly attractive investment environment or strong country specific advantages.

The theory outlines the country specific advantages as:

- factor endowments;
- familiar culture;
- cooperative political powers and political incentives¹⁴;

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¹³ See Jenkins (1992: 44-53) for an overview of the literature, its primary authors and its weaknesses.

¹⁴ Guisinger in his 1986 work outlined six principal attributes of investment policies or incentives which influence the locational decision. These included: the net value of the incentive; the variety of incentives; the stability of incentives; the timing of incentives; the investment promotion activities of the government; and the government services (1986: 159).

- low cost factors; strong market demand; and
- low level or limited competition for the MNE.

Just as the host government's power is based on its country specific advantages, the MNE's power is based on its firm specific advantages and the importance of the host government's goal to obtain benefits associated with those advantages. More important to this research, the MNEs goals are outlined as global profit maximization; access to future markets; and access to country specific advantages generally in the form of factors of production.

The Eclectic paradigm

Probably the most comprehensive model which has been developed in this area of study is Dunning's eclectic paradigm. Devised as a framework for analysis rather than a new theory, it encompasses the works of many authors. It provides a comprehensive outline of the issues in the majority of accepted theories governing the factors which affect multinational enterprises and foreign direct investment. Dunning, himself, characterized his approach less as an alternative theory and more as a pinpointing of the essential and common characteristics of the traditional explanations (Corley, 1986: 31).

The original model, developed in 1981, has over the years received much criticism and revision by both the original author and others who have used the model. The basic framework has remained relatively intact. The basic paradigm categorizes the issues affecting MNE activities and international production as: *Ownership advantages;*

Locational considerations; and *Internationalization advantages* (OLI)¹⁵. An examination of these factors explains the existence of multinationals and the reason for their growth and success in certain sectors or countries¹⁶.

Exhibit II-1 Outline of the Eclectic Paradigm or OLI Model	
I.	Ownership or firm specific advantages are defined as those factors which allow MNEs to overcome the cost disadvantages of producing in foreign markets and include: a) Knowledge based advantages including new products and process innovations, marketing and management skills, technological knowledge, and brand names; b) Oligopolistic market structure based advantages including patents, product differentiation, and economies of scale and scope; c) Excess managerial or entrepreneurial capacity; d) Financial and monetary advantages including access to capital and international diversification; and e) Access to raw materials and resources
II.	Locational advantages or country specific advantages (CSAs) are defined as those advantages possessed by MNEs based on their access to factors of production in foreign countries and tend to determine where the MNE will invest. They include economic, social and political factors such as: a) Economic factors: factor endowments of labour and capital, raw materials, production costs, technology, size of market, income, transportation and communication costs, management skills; b) Social considerations: political stability, psychic distance (language, culture, ethnicity, and business customs), ideology, and social factors; and c) Political or government factors: trade barriers, government regulations, and attitudes towards FDI.
III.	Internalization advantages stem from the MNE's ability to overcome exogenous and endogenous market imperfections in the market through internalization using the MNE's core competencies. Such competencies include: a) unique assets that come from firm size and access to markets, resources and intangibles; b) firm's ability to coordinate complementary activities; and c) global scanning which allows MNEs to exploit differences between countries.

(Source: Eden in her 1991 text Multinational Enterprises in the Global Economy

¹⁵ For a good outline of the factors considered important and their categorization see Exhibit II-1 which provides an outline of the model as developed by Eden in her 1991 text Multinational Enterprises in the Global Economy, text for graduate class at NPSIA, Carleton University.

¹⁶ Cantwell in his 1990 research demonstrated that the use of this paradigm can be expanded for analysis at the macro (economy), meso (industry), and/or micro (firm) level.

In Dunning's first outline of the eclectic model, he described *Ownership advantages* as:

- a) those which stem from parent company ownership of proprietary assets;
  - b) those which are normally enjoyed by a branch plant of any 'de novo' firms; and
  - c) those which are a consequence of multinationality 'per se'
- (Dunning 1981: 27).

Later this typology was amended to consider two basic asset types, Oa and Ot. Oa represents advantages based on assets held by the MNE and reflect the existence and natural or structural market distortions. Ot represents transaction based advantages and reflects the ability of MNE hierarchies to internalize transaction costs which would occur in the market (Dunning 1993 as cited in Dunning 1985: 3). The importance of this distinction is the recognition of two distinct but equally important and interrelated types of market imperfections, structural and transactional. This sets the stage for Dunning's third category of advantages; those stemming from the MNE's ability to exploit its ownership advantages to take advantage of and internalize market imperfections.

One of the primary advocates of *Internalization advantages* was Rugman who, in 1980, promoted the internalization theory as the primary explanatory factor for MNE behaviour. He argues that the MNE is:

an organization which uses its internal market as a means of producing and distributing goods efficiently in conditions where... market failure occurred (Corley, 1986: 6).

Market failures are classified by Dunning as either endogenous or exogenous. Endogenous imperfections are created by the MNE establishing an oligopolistic market structure and encompass any actions taken by an MNE designed to create barriers to entry and distort resource allocations. Such actions include the exploitation of patent

protection and other means used by MNEs to by pass government regulations designed to stimulate competition and efficiency.

Exogenous market imperfections are those which the MNE has no power to control and are divided into two categories; government imposed, and natural. Government imposed market imperfection include such things as tariffs and other trade barriers, tax rates, and any other government policies which affect MNE profits and activities (i.e. inadequate patent coverage of proprietary information or policies which discriminate against foreign companies)¹⁷.

Natural imperfections, as the name implies, are naturally occurring imperfections in the market which are based primarily on two factors:

- The pricing of knowledge¹⁸: Knowledge, while commonly considered to be a public good, incurs private costs in its generation thus encouraging MNEs to prevent it from being dissipated. The most effective way to do this is through foreign direct investment which ensures that control over knowledge is maintained in the hands of its proprietor, the MNE; and
- Transactions costs stemming from inefficient markets: buyer and seller uncertainty, quality control, difficulty of making sales contracts, uncertainty, and imperfect information.

Through its ability to internalize market imperfections the MNE is able to ensure that knowledge is not freely disseminated and that any potential benefits stemming from it are realized by the MNE. Transactions costs are decreased by eliminating the 'middle man'.

Finally we come to Dunning's second category: *locational advantages*. These

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¹⁷ According to Casson it is these government imposed imperfections, designed to curb such MNE strategies as product differentiation and price discrimination, which cause MNEs to internalize the market through FDI.

¹⁸ Casson in his research provides a good working definition of knowledge. He equated it with technological knowledge, marketing intelligence, and entrepreneurial skills (Corley, 1986:32).

are the factors which tend to determine where the MNE will seek out FDI opportunities.

According to Dunning locational decisions depended on:

- a) The extent to which products require special adaptation to different national markets;
- b) The production and process structure of the firm in particular the extent to which it is horizontally or vertically diversified;
- c) The size and significance of tariff barriers¹⁹
- d) The quantity of output supplied before tariff reduction;
- e) Elasticities of demand and supply in the various locations;
- f) Economies or dis-economies of scale in production;
- g) Transportation costs;
- h) Availability and prices of inputs; and
- i) Government policies on trade and investment.

(Buckley, 1989)

These factors can be categorized as Economic factors, Social considerations, and Political or government factors (See Exhibit II-1). The general premise being that FDI will tend to move to countries which are similar in terms of: social factors; political and economic stability; favourable attitudes towards investment; geographical proximity; and good factor endowments and resources. Only after full consideration of all of these factors will the MNE decide to enter a given market.

The primary value of Dunning's work to this paper comes from several sources. First the discussion of locational factors provides an excellent overview of the factors making up the investment environment. Next internalization advantages demonstrates how MNEs are able to overcome some of the problems which they face in an international environment. This also provides insight into the strategic goal of the MNE through the discussion of market imperfections and the need to internalize those imperfections as one of the driving forces for FDI.

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¹⁹ Much work on the effects of tariffs and tax rates on MNE investment decisions has been done by Horst.

International Value Chain

The International Value Chain was developed by Porter, as an extension of his earlier Value Chain analysis. It explains the strategic management and decision making of MNEs. According to Porter's theory, a firm is a collection of discrete activities which are performed in a certain way in order to function and compete in a given industry. These activities are called value activities and their coordination makes up the value chain.

The activities of the value chain are classified as either primary (production, sales and service) or support (infrastructure, human resources, research and development). Primary activities are further classified as upstream or downstream oriented where upstream refers to production related functions and downstream refers to sales and marketing related corol (Exhibit II-2).

**Exhibit II-2
International Value Chain**

s a u c p t p i o v r i t t y	Firm Infrastructure					m a r g i n
	Human Resource Management					
	Technology Development					
	Procurement					
	Inbound Logistics	Operations	Outbound Logistics	Marketing and Sales	Service	
	Primary Activities					
	Upstream Activities			Downstream Activities		

Source: Porter, 1986: 21

Within the realm of each activity a series of decisions must be made which may affect decisions in other activities. This may require a certain level of coordination which forms the links in the chain - what Porter calls linkages. According to the theory first the firm must decide and shape the length of its chain and then adjust its strategy and structure accordingly. Porter argues that strategy is constrained and dictated by the value chain.

Internationally, MNEs can locate different stages of the value chain in different countries thus taking advantage of the country's respective locational advantages as well as the internal advantages resulting from the ability to coordinate the value chain activities and create a competitive advantage. The model specifically discusses the decision to locate downstream and upstream activities in different nations. It argues that typically firms locate downstream activities (sales marketing) in the countries in which they operate and that upstream (production) and support activities are generally found in the countries where those activities can be carried out most efficiently and coordinated most effectively.

The Value Chain is based on the concept that the MNE will locate activities where it is most efficient both in terms of the MNEs ability to coordinate activities and to take advantage of country specific advantages. The country specific advantages then form a part of the investment environment. On the issue of the MNEs strategic goal, the discussion of upstream and downstream activities would imply that the goals are either market oriented (downstream activities) or production oriented (upstream activities).

Competitiveness of Nations

Porter's next work in the area of international business and the MNE deals with the effects of the home nation on the MNE. While this topic is beyond the scope of this research, the theory does provide some insight into what factors are considered to be of most importance to the MNE and how a country's (home or host) factor endowments can affect the actions of the MNE. In his model, Porter outlines what he calls the *diamond of competitive advantage* (Exhibit II-3).

Exhibit II-3

Diamond of Competitive Advantage

Source: Porter 1990: 133

The most important point in the diamond for this research is the Factor Conditions. Porter describes such conditions as either basic or advanced²⁰ and either specialized or generalized. In an attempt to create a hierarchy of the importance of these factors, he states that advanced factors are more important than basic factors because

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²⁰ Basic factors include: natural resources, climate, location, unskilled & semi-skilled labour, and capital. Advanced factors include: telecommunication & infrastructure, skilled labour, and research institutes.

basic factors are either readily available locally, or easily sourced internally through the MNE's international market. He makes the same point regarding specialized and generalized factors pointing out that generalized factors are generally available and a lack of them is easily circumvented by sourcing through global networks (Porter 1990: 77-83)

In Chapter 10 of his book, The Competitiveness of Nations, Porter goes on to discuss the implications of the diamond on the corporate strategy of the MNE. He describes the policy of what he calls the "tapping of selective advantages in other nations" and outlines the various reasons for international expansion as:

- Serving sophisticated buyers and markets;
- Global Production;
- Foreign sourcing;
- Technological development abroad; and
- Locating Regional Headquarters. (605-610)

Specifically discussing the acquisition decision he says that:

Foreign acquisitions can serve two purposes. One is to gain access to a foreign market or to selective skills ... the other ... is to gain access to a highly favourable national *diamond* (1990: 611).

From this summary it can be concluded that the theory would predict that the MNEs strategic goal would be either market seeking, or production oriented - exploitation of a country's advantages or skills.

Incremental Internationalization

Incremental internationalization models²¹, as a generic type, advocate a gradual approach to international activities. The theory evolves around the concept that the MNE

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²¹ Authors which have advocated this approach include Buckley, Newbould, and Thurwell (1987) in Foreign Direct Investment by smaller United Kingdom firms. London: Macmillan.

engages in international activities on a gradual basis gaining experience which is used for subsequent activities. Therefore the MNE will commence with the least expensive or risky expansion option: exporting to a similar market. As it gains experience it will increase its commitments to that market and expand to other, more risky markets²². The reduction of risk and uncertainty is a primary determinant of this cautious approach and provides the basis of this model. Direct investment is regarded as the most risky form of entry (Buckley, 1989: 79).

The applicability of this model has been discussed by several authors including Buckley (1989) and Young (1987:39). Both point out that the model should be limited to products with relatively long product life cycles. For products with short life cycles in high technology sectors the implications of competition on a global market limit the applicability of a gradual approach.

This model is applicable to this research in two ways. First it predicts that the primary motive for FDI is market expansion. Secondly it the concepts of experience and risk, pointing out that the FDI option is the most risky of the market expansion options available to the MNE.

International Business Environment

In their widely accepted international business textbook, International Business: Environment and Operations, John D. Daniels and Lee H. Radebaugh provide an

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²² Johnson and Vahlne (1977) have also done some work in this area, arguing that the choice of entry mode is determined by "an evolutionary process by which a firm advances from exporting to joint venturing to wholly owned subsidiaries to the reduction in perceived risk regarding the foreign market as a firm gains in experience" (cited in Kogut, 1988: 412).

extensive overview of the factors which affect the decisions of MNEs in their international operations, with particular relevance to external environmental factors.

According to their book:

Operations in the worldwide environment are affected by social science disciplines [geography, history, political science, law, economics, anthropology] and cover all functional business fields (1989: 11).

Specifically the authors outline the influences on trade and investment patterns as:

- Economic conditions, technology, geography and history, wars and insurrection;**
- Political relations (political blocks & multinational agreements); and**
- Cultural barriers**

The economic and political environments are defined based on their systems.

Political systems are either democratic or totalitarian. Economic systems include; market, centrally planned, or mixed. The authors also consider ideological factors, whether the country is a plural or singular society.

Human and Cultural environments are defined as the variance of cultures in terms of: appearance; behaviour attributes such as group affiliations; the importance of work (ie. the protestant work ethic, belief in success and reward, work as a habit, high-need achievement); the importance of occupation and self reliance; communication including both spoken language and silent language (perceptions, processing and evaluation of information); morals and etiquette; ideology; religion; historical relations; and geographical location.

The concept of national culture has been an area of fairly extensive study as international barriers to trade and investment fall and cultural barriers become more

important. The basis of the argument is that cultural or psychic distance between the home and potential host nation greatly affects both location and mode of entry decisions (export vs FDI, etc.)²³:

Due to the difficulty of integrating an already existing foreign management, cultural differences are likely to be especially important (Kogut, 1988:413).

This is argued to be particularly true in the case of acquisitions where the fit of the two firms is crucial. This fit being defined as "the match between administrative practices, cultural practices, and personal characteristics" (ibid).

The strategic goals of MNEs are also addressed by Daniels and Radebaugh as they summarize the primary objectives of foreign direct investment as: to expand markets by selling abroad; and to acquire foreign resources (raw materials, production efficiency, knowledge). Market expansion or demand oriented investments are designed to:

- avoid transportation costs;
- compensate for a lack of domestic capacities;
- overcome government imposed and consumer imposed trade restrictions such as tariffs and customer preferences;
- follow customers or competitors; and
- take advantage of changes in comparative costs.

Supply oriented investments are explained as:

- taking advantage of benefits associated with vertical integration;
- rationalization of production;
- access to production factors, government investment incentives, and
- the above mentioned product life cycle theory.

This literature is useful in this research both in its detailed outline of the factors

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²³ Work in this area has been carried out by several authors including Kogut (1988), Johnson (1977), Dubin (1975), Caves (1986), and Anderson (1987).

which make up the international business environment and affect the investment decision, and its discussion of the strategic goals.

East European Specific Theories

In a 1991 essay: "Western Theory and East-West Joint Ventures", Carl McMillan provided a review of the applicability of FDI theory to the situations in these countries, with particular reference to joint ventures. At the time the joint venture was the most prominent mode of equity investment in Eastern Europe and the former USSR. He defined the East-West Joint Venture (EWJV) specifically as a form of FDI:

Institutionalizing East-West inter-firm cooperation in an identifiable organizational entity, through which the parties pool assets in a mutual endeavour, jointly manage operations and share the associated risks (McMillan and St. Charles 1974) ...Given this element of participation in the management of assets, an international joint venture may be viewed as a form of foreign direct investment (McMillan 1992).

McMillan drew on Western theory to provide four propositions explaining the motivations of western companies forming EWJVs. Of these four, three are oriented specifically to the joint venture. Only one is truly applicable to FDI in general. This proposition predicts that: "The benefits and costs of internalization form the core of the economic rationale for EWJVs" (McMillan, 1991). McMillan argues that internalization advantages are the primary motivators driving MNEs to engage in FDI or Joint Venture activities.

This issue was also addressed by Dunning in his 1991 article "The Prospects of Foreign Direct Investment in Eastern Europe". In this article Dunning pointed out that:

We would anticipate that at least the larger MNEs will respond to the challenges and opportunities of Eastern Europe in terms of its likely affect on their global marketing and production strategies ... firms view Eastern Europe as offering an enlarged market for their products, thus enabling them to spread increasing overhead costs of R&D and Marketing; and by so doing enabling them to compete more effectively (Dunning, 1991: 10).

CONCLUSION: Predictions on Strategic Goal and Investment Environment

Why are MNEs investing in the privatization of Hungary's SOEs despite the difficulties associated with an unstable investment environment and negative legacies of the communist period? What are the problems they face and issues they consider when making this decision and how are these problems being overcome?

Given the above research questions, how does the literature review help in developing a thesis predicting the MNEs strategic goal and the problems inherent in the investment environment.

Strategic Goal

The literature reviewed in this survey considers the analysis of a variety of factors to explain why MNEs invest internationally. The predictions of these theories regarding the strategic goal of the MNE are not all the same but there are some common threads. All of the strategic goals outlined in the theories can be classified as either market seeking or production oriented (Exhibit II-4). More specifically the MNE's goals can be considered as either:

- a) Access to markets where, through FDI, MNEs can internalize market imperfections and achieve a competitive advantage; or
- b) Resource seeking, be it access to raw materials, production efficiency, expansion of production activities, labour, technology, and/or knowledge.

Exhibit II-4 Conclusions regarding Strategic Goals		
Model	Market oriented	Production oriented
Product Life Cycle	•seeking new markets for mature products •protect existing markets by creating entry barriers in foreign markets •Bunching principle to overcome competition	•seek lowest cost production to overcome production. •production efficiencies. •geographical proximity.
International Division of Labour	•create entry barriers based on knowledge and technology.	•Production efficiencies based on country specific comparative advantage and specialization.
Bargaining Theory	•access to markets	•exploitation of country specific factors.
Eclectic Paradigm	•Internalize market imperfections both natural and govt imposed. •creation of barriers to entry in foreign markets.	•Take advantage of locational advantages including resources available.
International Value Chain		•Locate enterprise activities where most efficient taking advantage of Country Comparative advantage.
Competitive Advantage of Nations	•serving sophisticated buyers and markets •access to foreign markets	•global production and foreign sourcing of resources and technology. •access to selective skills or favourable national diamond.
Incremental Internationalism	•expansion to new markets.	
International Business Environment	•expansion to new markets.	•acquire foreign resources.
Eastern Europe Specific	•Market access and internalization advantages.	•global production strategy.

What about the applicability of these theories to the specific situation in this research? Do these theories also apply to the situation in the transforming economies of East Central Europe? Initial predictions found in the East European specific theories

considered would say that the conclusions hold. According to the limited emerging literature on FDI in these countries, the primary motivators for FDI are to take advantage of market imperfections through internalization of the market. Market access and incorporation of these economies into the MNE's global production strategy are the driving forces for MNEs investing in East Central Europe. Literature would suggest that it is the first motive, market access, which is the more important driving force.

Investment Environment

Exhibit II-5 provides a summary of the country specific elements which the above theories outline as factors affecting the investment decision. These elements can be considered as a framework for analysis of the investment environment as seen by the MNE. The relative importance of these factors is touched on by Porter when he discusses the hierarchy of basic versus advanced, or generalized versus specialized, factors. He points out that the MNE is able to overcome or circumvent many problems, particularly in the area of basic or generalized factors, by sourcing these factors through global networks. Dunning and Rugman refer to a similar concept in their discussion of internalization advantages where the MNE is able to internalize market imperfections.

Those problems in the investment environment which the MNE cannot render neutral through internalization or global sourcing form the basis for determining the risk of the venture. Depending on the area of business and the particular goals of the MNE, the importance of those problems may differ and the MNE may be willing to overlook some unfavourable elements which would normally increase the risk of the investment.

In making the investment decision the MNE must assess this risk vis-a-vis the return, or benefits, it expects to gain in terms of the importance and likelihood of achieving the strategic goals.

Exhibit II-5 Investment Environment Factors Affecting the Investment Decision	
Factor Endowments	• Labour, capital, raw materials, production costs, energy, technology. • Market size, income. • Management skills
Infrastructure	• Transportation • Communications
Cultural	• Psychic Distance- culture, ethnicity, language, business customs, and work ethics • Historical factors- political/economic ties, wars • Geographic Proximity
Information	• Availability • Accuracy and applicability
Macroeconomic	• Economic System and Stability
Political	• Political System and Stability
Governmental	• Legislative Environment • Government Attitude Towards FDI
Ecological	• Ecological Issues and Problems • Government Attitude Towards Ecological Issues

Development of The Thesis

From these conclusions, the following thesis or proposition can be created:

The strategic goals of MNEs acquiring controlling interest in former state owned enterprises in Hungary's manufacturing industries can be categorized as either market seeking or production oriented. Market oriented goals are the more prevalent. MNEs are pursuing these goals despite the many difficulties associated with an unstable investment environment and negative legacies of the communist period.

This thesis can be broken down into four points which to be tested according to the Hungarian situation:

1. The investment environment in Hungary is unstable and riddled with negative legacies of the communist period;
2. Multinationals remain interested in the country despite the above statement about the environment;
3. The strategic goals of MNEs can be considered as either market access or production oriented and market oriented goals are more prevalent; and
4. MNEs are able to overcome the problems which are inherent in the investment environment.

Chapters III and IV provide an analysis of the investment environment in Hungary and the issues specific to privatization which are relevant to the MNE. These chapters test the first point above and lay the ground work for the analysis of the case studies. Once point one is established, chapter V tests the thesis that MNEs continue to invest in Hungarian privatization through an overview of the FDI and privatization experience in Hungary over the period of study. Chapter VI provides an overview of the cases considered and assesses their strategic goals according to the criteria of point three above. Finally, in chapter VII, point four is appraised through consideration of the

specific problems raised in the analysis of the case studies showing which of the problem factors raised in the first point had a strong effect on the cases and how those problems were overcome.

CHAPTER III. HUNGARIAN INVESTMENT ENVIRONMENT

This chapter attempts to demonstrate that the investment environment in Hungary is unstable and to outline some of the negative legacies inherited from 40 years of the communist system. Using the criteria set out in chapter II, an assessment of the factors making up the investment environment in Hungary lays the ground work for the analysis of the remainder of the study²⁴.

FACTOR ENDOWMENTS

A country's factor endowments include: inputs to production (labour, capital, raw materials, production costs, energy, and technology); market size and income levels; and managerial skills (human resources, accounting and marketing). It is these factors which will initially attract the attention of the investor, either as part of a production oriented or market access strategic goal.

Labour

One of Hungary's stronger selling points for attracting foreign investment is its skilled and relatively inexpensive labour force. In 1991 average net salaries were approximately USD 275/month (HUF 22,000) and, while wages continue to increase steadily, it is not expected that they will reach Western levels for at least another five years.

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²⁴ A detailed discussion of the factors found to be problems in the case studies considered is found in Chapter VII along with how the MNE is able to overcome or circumvent those problems and make the investment viable.

Many investors have found, however, that this low net salary level can be deceiving. When low productivity levels and high social benefit costs are considered, the attractiveness of Hungary as a source of cheap labour may decrease. While net salaries in Hungary are relatively low, the total costs to the employer tend to be much higher than expected. High personal income taxes and social securities payments of up to 49% of gross salary increase payroll costs.

Capital

Capital is one of the least abundant factors in Hungary and is one of the primary driving forces of the Hungarian government's desire to attract foreign investors. The Hungarian economy needs injections of high levels of capital and the supply of domestic capital is not sufficient to meet this demand. While statistics show increasing levels of domestic savings, this capital is not concentrated and governmental policy options designed to mobilize such capital are limited by the IMF and the economy's macroeconomic problems such as the high external debt. Added to this is the high interest rates being demanded by banks - 30% in April 1992 as compared to an effective rate of about 10% in the West - and a young banking system which has not yet developed sophisticated financing or credit assessment techniques²⁵.

Raw Materials

The Hungarian economy's strength has been in agriculture with limited

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²⁵ Further discussion of Hungary's banking system and capital markets is found later in this chapter under infrastructure.

endowments of oil, gas or mined materials. The large fertile agricultural area has always provided the economy with an adequate source of food products and inputs to food processing. Since the industrial evolution under the Communist system, the economy has expanded to become a major source of chemical products used as inputs to industry and pharmaceutical manufacturers.

Production/Expansion Costs

Investors have found that costs of expansion in Hungary are less than in Western Europe, even when lower levels of efficiency and high costs necessary to bring facilities up to standard are factored in. This is expressed to be one of the greater attractions for MNEs who face high costs of expansion to meet demand from both West European markets and the newly emerging markets of Eastern Europe and the former USSR. Land and construction costs are less in Hungary and it is possible to get a good deal in the purchase existing manufacturing facilities through privatization. In addition, MNEs can take advantage of various subsidies provided by both domestic and international governments aimed at the development of the region.

With respect to production costs, one Italian producer pointed out: "we estimate costs of production at our Hungarian facilities to be as much as 13% less than similar facilities in Italy"²⁶. These benefits may be diminished by low levels of efficiency and poorly maintained production facilities.

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²⁶ Interview with Mr. Matiello, managing director of Hantarex which is an Italian manufacturer of computer monitors operating in Pecs.

Energy

The loss of subsidized energy from the former Soviet Union has wreaked havoc on the costs of energy in Hungary as the country has limited domestic sources. After forty years of COMECON trading, Hungary had become reliant upon the former USSR for energy. As such it had not developed its own domestic potential nor had it sought other external sources. With the collapse of COMECON, Hungary had to seek out new sources of supply and had to pay market prices for its energy. Through the non-market oriented pricing system used in COMECON trade the USSR had been in essence subsidizing Hungarian industry through low priced energy products²⁷. The dramatic increase in the cost of energy imports together with losses in markets from decreases in COMECON trading is said to be one of the largest contributors to the downfall of Hungary's manufacturing companies.

Technology/Production

The standard of technology and production techniques in Hungary varies according to the industry and company being considered. In general, companies have a mixture of different technologies. Some of the technology is up to date and modern and some of it is obsolete. The level of technical advancement tends to depend on the priority given to the industry and the company by the former government as well as the

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²⁷ This concept of the USSR subsidizing the East European nations has been debated by researchers who argue that the prices under the former system were logical and cannot be considered as subsidies simply because they were lower than market prices. However the effect was the same that with the end of COMECON and the conversion to market price trading, the East European countries faced significant raises in the price of energy.

bargaining powers of the company's management. Under the old system the government would allocate investment capital to companies on the basis of several factors including the ability of management to put its case to those in the charge of the money. This ability often depended more on who you knew and what you could do for those making the decisions than on the potential profitability of the investment. Upkeep of machinery has tended to be erratic as parts were difficult to find and the incentive for upkeep and maintenance was often lacking.

Market size/Income

The Hungarian market is small and in comparison to Western Europe the income, at least officially, is extremely low. The market seems relatively unattractive with a population only 10.3 million - of which only 67% fall in the largest spending age range of 15-59 years - and an estimated per capita income of USD 2,750 per year²⁸. Average annual income for 1990 was estimated at around USD 3,000. The attractiveness of the Hungarian market comes from the fact that: it represents an unsaturated emerging market which has relatively sophisticated demands; and it is seen by many investors as a springboard to both East and West.

Management skills

Hungarians saw managerial skills and know-how as the primary benefit of foreign investment. A lack of effective management skills is believed to be one of the major

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²⁸ According to a 1991 OECD report on the economic situation in Hungary.

problems leading to the downfall of many SOEs. With the reforms to a market oriented economic system, there is a strong need for effective market oriented management skills. Everything from effective human resource planning to accounting and marketing were and are needed to bring the former SOEs into position to compete in a global market. While the situation is believed to be improving as more Hungarians are getting proper training and learning new managerial techniques, the unbalance between the demand and supply for good managers continues to increase (DRT, 1992).

Human Resource Management

Underemployment; low productivity; ineffective incentive programs; and a lack of training programs are problems of human resource management which must be addressed. These factors were not considered to be important under the old system and such things as worker assessment, career planning, retraining, and personnel recruitment were either ignored or dealt with inadequately.

Accounting and Financial Management

Under the communist system in Hungary the accounting system used was geared to help state planners allocate resources and collect taxes. It neither met international standards nor provided managers with the necessary information to effectively manage a profit oriented company. As one expert in the industry pointed out:

Accounting rules in the Eastern European countries have been ... highly regulated. [they] were not designed to assist management in running the business, nor necessarily aimed at disclosing profit; they were designed to monitor compliance with the annual, central plan (Toltzman 1992/93:27).

Exhibit III-1 provides an overview of the differences between Hungarian and Western accounting systems.

Exhibit III-1
Differences Between Hungarian and Western Accounting
• Consolidated financial statements were not required in the Hungarian system   • Deferred taxation accounting was not necessary   • Capital leases were reported as operating leases.   • Intangible assets were only capitalized if they were specifically acquired.   • All property and plant had to be capitalized at the historic cost by the legal owner. There was no provision for revaluation.   • Fixed assets were depreciated in accordance with straight-line depreciation methods at a rate determined by the Ministry of Finance.   • Inventories were carried at cost which included expenses such as customs duties and transportation costs.   • No global provision was permitted for obsolescence or bad or doubtful debts.   • All foreign currency receivables/payables and cash balances must be translated into forints at year end. Exchange gains or losses were treated as income or expenses.

*Source: Economist Publications "Investing in Eastern Europe and the USSR: Financial Strategies & Practices for Successful Operations" (1991).

The effect of this system on the potential investor is twofold. First, the difference in the book keeping system means that the information necessary to make an educated investment decision is not available and the investor must rely on less than optimal methods for determining the value of the target company. Second, the majority of financial reporting is currently done manual with no automation. The MNE faces the prospect of having to implement a new financial reporting and accounting system as one of its first actions after acquisition. It must not only find people with an understanding of accounting but also must bring in an automated system and provide adequate training.

Marketing

A lack of any knowledge in marketing and distribution has been a major problem in Hungary as well as the rest of Eastern Europe and the former USSR. Under the old system there was no need to seek out buyers since production and distribution were according to the plan. Since it was an economy of shortages in most goods, efforts were directed more towards finding suppliers rather than buyers. The result: an economy with essentially no understanding of marketing or advertising and a distribution system designed for large trading between state owned enterprises rather than the provision of goods to buyers in an effective and efficient manner.

INFRASTRUCTURE

Banking

Hungary first established a two tiered banking system in 1986. Commercial banking activities were split off from the National Bank and the loan portfolios were allocated (according to function) to three new banks. These new banks were: the Kereskedelmi (Commercial & Credit) Bank, the Budapest Bank, and the Magyar Kulkereskedelmi (Foreign Trade) Bank. Since 1986 numerous other commercial and investment banks have been formed either as a joint venture with a foreign bank or as a transformation of a previously state owned financial organization.

While on the surface the system appears to be sophisticated and operational, several problems still exist (Exhibit III-2).

Exhibit III-2
Problems with the Banking System

- *Cash is scarce* Demand for cash has tended to exceed supply and the inter-bank market has not yet developed. There is a large intercompany debt.
- *Political control* Banks remain largely agents of what is left of the central planning mechanism.
- *Bad Debt* The banks hold a large amount of bad debt which must be written off but there is no system in place to do this without causing a complete collapse of the banking system.
- *Service Orientation* There is little customer service orientation since the banks face little competition and the majority of banking activity is government oriented.

Source: Economist Publications "Investing in Eastern Europe and the USSR: Financial Strategies & Practices for Successful Operations" (1991).

Many investors complain that the system is underdeveloped and slow, and lacks a focus on customer service. This causes great frustration, particularly when it can take up to four weeks to process inter-bank transfers from external banks. This time lag is unreasonable and leads to a loss of potential revenues.

Hungary, in general, has remained a cash based economy where people and firms often do not even have bank accounts. Bills and salaries are often paid in cash. This not only ties up revenues but it also leads to a greater risk for the loss of funds and facilitates fraud or the siphoning of company funds. The lack of a banking mentality in Hungary comes in part from a valid distrust of the relatively young and developing banking system. A lack of service orientation in the banks compounds problems and is due to a lack of competition and the fact that the majority of banking in the past was between one government agency and another.

Another area where there are problems inherent in the system is obtaining credit from the banks. An investor wanting to secure short or long term debt faces a situation where cash is limited and effective corporate lending procedures are not yet in place.

A cash based economy means that bank savings are low. This combined with an underdeveloped inter-bank market limits the cash available for lending. Even when cash is available, banks have tended to prefer guaranteed government bonds over corporate lending. The Hungarian banking system is burdened with the inheritance of substantial bad debts making the banks leery of incurring further corporate debt. Bankers are more accustomed to dealing with government agencies than with private companies or persons.

Additionally, banks have not yet established appropriate credit assessment procedures. Even where banks have adopted Western type credit assessment procedures, they are not generally willing to extend the flexibility required by the situation in Hungary. Western accounting techniques have only been in place since the year end of 1990 and most companies in Hungary are less than one year old. This means that historical financial data is not available for analysis. Also, a lack of market information and an instable market environment makes projections difficult and not very reliable.

Capital Markets

Capital markets in Hungary, while advanced in comparison to the other former socialist countries, are very young and unsophisticated relative to the West. Hungary first allowed the issuance of corporate papers, or bonds, in 1982. These papers had a government guarantee for repayment and a fixed interest rate. In 1988, the government removed its guarantee and put a ceiling on interest rates. This led to the collapse of the primary market for such papers, but a secondary market remained in place where such papers were traded amongst banks. The sale of shares in private companies was allowed

by the 1989 *Company Act* which led to the emergence of a strong informal market. Banks converted debt into equity and this equity was often traded on the informal market. The Budapest Stock Exchange reopened in June 1990 after over 40 years.

The stock exchange has had several problems and a slower than expected start. Not the least of these problems was strict listing requirements which the majority of companies could not meet²⁹, and difficulties in the valuing of shares. Shares did not trade well in the initial stages since they were generally overpriced. A lack of domestic institutional investors and concentration of domestic capital together with strict limits on foreign portfolio type investment³⁰ added to this problem. The outcome has been a relatively unsophisticated and inactive capital market in Hungary leading to difficulties in obtaining capital and a stronger need for foreign capital. In response to the difficulties associated with securing capital both through the banks and the capital market, a Strong informal market for corporate papers has emerged in Hungary which has allowed more well known companies to go directly to potential investors for capital (BEE, 31/08/92).

Telecommunications

In a survey of foreign investors operating in Hungary 28% of all respondents sited problems with telecommunications in Hungary as "very severe" and 35% rated them as

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²⁹ Requirements for listing on the exchange were relatively strict when considering the number of companies which would qualify in Hungary. The company must have capital of greater than HUF 2 million (USD 30,000), over 50 owners, 25 % of shares publicly traded, and two years of audited balance sheets. January 1992 brought the beginning of the BSE index which started at a level of 1000 and by March 1993 had fallen to 700.

³⁰ Portfolio investment, unlike direct investment, does not involve any control over the management of the company and remained restricted in Hungary.

only "severe" (DRT, 1992). Telecommunications is one of the most commented upon infrastructural problems facing investors in Hungary. According to an article in the Wall Street Journal, "Going Private: In Hungary, they're lining up for a stake in the phone company": there are only 11 telephone lines per 100 people in Hungary. That is about one sixth that of West Germany and it cannot compare to North America where there is the highest per person number of lines in the World. About one million Hungarians wait for phone lines with an average wait of five years. People dialling a number have a 45% chance of getting through on their first try and many secretaries still bash away at telephones the size of typewriters (WSJE 08/04/92).

The situation in Budapest is not as bad as that of the rural areas where some towns have no telephone lines. To reach a company or person in such a town it is necessary to call the post office in a nearby town (up to 25 km away) and leave a message. That message is then delivered to the party you are trying to reach who must then go to that post office to call you back. If you are lucky, you make contact within one or two days³¹.

Transportation structure and Utilities

Public transit is excellent in large cities and inexpensive since it is highly subsidized. Public transit between major cities is reasonable but not adequate with buses leaving two to four times a day and trains leaving once or twice a day. Roads in major cities are relatively good and have been fairly well kept, but in rural areas and small

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³¹ Based on personal experience trying to reach a client in a small town in central Hungary.

villages roads are not well kept. The transportation infrastructure is insufficient to service the growing number of automobiles and access to newly developing areas.

Utilities are adequate in large cities but insufficient and run down in rural areas. The establishment of new systems may take years to accomplish. Investors have commented that it can be advantageous to buy an existing operation rather than to start a new investment if only for the fact that the existing entity will have an established utility system.

CULTURAL FACTORS

The cultural factors which influence the investment decision include: culture and ethnicity; language; business customs and work ethics; historical economic and political ties, and geographical location.

Culture and Ethnicity

A country, or society's culture is defined as its norms of behaviour based on attitudes, values and beliefs (Daniels & Radbaugh, 1989). Its ethnicity is defined by the people's country or race. In Hungary, this is talking about are the characteristics which make Hungarians what they are and attempt to explain their behaviour.

Hungary, unlike its East European neighbours is made up of one primary ethnic group: Magyars³². While Hungary's neighbours struggle politically with ethnic fighting

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³² Magyars is the Hungarian language term for Hungarians and is derived from the original tribe which settled the area, the Magyars.

resulting from the intermixing of several ethnic groups, these problems have not been felt in Hungary. Some racial backlash has been seen against immigrants to Hungary, but this has not been as bad as the racial backlash observed in other European countries.

Problems related to ethnicity have been more prevalent on the international front than domestically. There are over two million ethnic Hungarians living in other countries making it the largest minority group in Europe (The Economist, 03/13/93). The majority of them live in the regions bordering on Hungary - Slovakia, Rumania, and Serbia - which were once a part of Hungary but were lost after WWI.

While there has been no official talk of Hungary trying to recapture those territories lost through the June 4, 1920 Treaty of Trianon, the issue has been a subject of some debate and has led to international political instability in the region. Official Hungarian policy has been not to interfere or make demands on behalf of Hungarians abroad but the government has been known to support reasonable demands of these ethnic Hungarians when they are made (The Economist 03/13/93: Survey 18). The tolerance of the Hungarian government towards its neighbours, particularly in the area of their treatment of ethnic Hungarians, is seen to be increasingly difficult to sustain. There have been international incidents and negotiations as result of what is perceived as Hungarian interference on the behalf of Hungarian minorities.

Language

Interestingly enough language has been considered of secondary importance to investors in Hungary. The Hungarian language is considered to be the most difficult

European language to learn since it bears no close relation to any other European language. However, there are many Hungarian Nationals who left during the 1956 revolution and who were brought up in Western cultures. The majority of investors have brought in Hungarian Ex-patriots to start up their operations.

Furthermore, the business community in Hungary has adopted English or German as the major languages of correspondence. Knowledge of Hungarian, while a definite benefit, is not a necessity. Hungarians have been quick to learn English at a proficiency that would be the envy of most nationalities.

Business Customs and Work Ethics

Labour and managerial issues in terms of work ethics and business customs are particularly important in the case of acquisitions where the 'fit' between the target enterprise and the investor can be crucial to the viability of the proposed venture and where work patterns and labour force are already well entrenched. In Hungary these can be seen to be a major issue to be overcome as the work habits and customs inherited from 40 years of communism must be changed³³.

Economic & Political Ties

Hungary has had strong ties with Austria going back as far as the Austro-Hungarian Empire, and before. The country has always been internationally oriented and

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³³ Specific examples of these customs will be provided in Chapter VII where the specific concerns raised in the case studies are examined. Also see Journal of Comparative Economics vol 15, 1991 for a series of articles discussing the effects of communism on business customs and work ethics.

this continues to be seen in its dedication to early membership in the European Community (EC). This has been complemented by attempts by the country to re-establish trade ties with its former partners in the COMECON trade union. These ties not only demonstrate the Hungarian government's dedication to an open market economy but also increase the country's attractiveness as a source of investment by enlarging the potential market which can be serviced from there and facilitating the import of production inputs.

Geographic Location

Hungary is centrally located in Europe with easy access to Eastern and Western Europe as well as the former Soviet Union and the Middle East. Combined with lower costs of production and expansion, this makes Hungary an attractive location for production geared for both Europe and the Middle East. On the downside, however, Hungary is situated in the middle of civil wars and political strife as it borders the former Yugoslavia, with its long lasting civil wars, and on Czechoslovakia, with its political instability and threat of break up³⁴.

INFORMATION

Availability

The majority of available information on issues relevant to foreign investors and

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³⁴ Please note that shortly after the research period of this study Czechoslovakia did split into the Czech and Slovak republics. The breakup was peaceful.

in the area of trade & demographic statistics, can be found in English and German. English and German speaking people are usually available at all agencies where the investor might seek information. The most reliable source of information in Hungary are the publications of the Hungarian Central Statistics Office and the National Bank of Hungary.

In general, however, finding reliable and accurate information in Hungary is difficult. People are reluctant to give out information as it was considered to be a major source of power for over 40 years under communism. Access to information became equated with power and the dissemination of such information meant a loss of some of that power. Confidentiality was of primary importance. Added to this attitude of confidentiality is an information infrastructure which is not geared to gathering and disseminating the information the investor requires. Facts are often misrepresented and in some cases are out-right false. People trying to circumvent the system not only avoid restrictions and taxes but also official information gathering system.

Accuracy

Historical information from the above sources can be generally regarded as correct. However accurate timely information is difficult to obtain and there often exists discrepancies between sources. For example; GDP and foreign trade figures have been known to differ significantly between the central statistics office and publications of the Hungarian National Bank. This is attributed to the fact that the figures are calculated differently by each source. However, as was the case with year end figures for 1991,

the difference at times is so great it is impossible to believe that it is simply due to different calculation methods. Examples such as this strongly indicate that there are serious problems both with the way statistics are calculated and the way they are obtained. It is generally accepted that official statistics tend to overemphasize negative trends. They are based on the large industrial SOEs and do not fully reflect the growth of small and medium sized private retail and industrial sectors which are the most dynamic elements in the country's growth.

ECONOMIC SYSTEM & STABILITY

The term used to describe the current economic system in Hungary is *Transforming Economy*. This in itself conveys a degree of instability which must be recognized and taken into consideration in all decisions. While there have certainly been many problems associated with the transition in Hungary, the process has been less painful there than in the other former socialist economies. This is primarily due to the country's progress under prior economic reforms and its ability to pursue less radical programs.

The effects of the transition has nonetheless been particularly hard felt in Hungary's industrial sectors, which prior to 1990 enjoyed a high level of government subsidization and easy access to COMECON markets³⁵. Early in 1990 the Hungarian government put severe limits on ruble exports by heavy industry, machinery and engineering companies. Subsidies were also reduced for these industries, as the

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³⁵ According to official government statistics, average monthly output for all industrial sectors as at December 1991 had declined to approximately 64% of January 1989 levels.

government continued to shift the economy toward a more market-oriented position. These factors forced companies to find new markets for their products in the West or face bankruptcy and collapse³⁶. The restructuring and down-sizing that has taken place as a result has been particularly painful for the manufacturing sectors, which as of August 1992 had declined to about 40% of 1985 production in real terms³⁷.

Exhibit IV-1 Main Economic Indicators						
<i>Domestic Economy</i> (Percentage Growth)	1987 %	1988 %	1989 %	1990 %	1991 %	1992* %
Industrial Production	3.8	0.0	-1.0	-9.2	-21.5	-10.5
Consumer Price Index	8.4	15.8	16.9	28.9	35.0	21.6
GDP Growth	4.1	-0.1	0.2	-4.0	-8.0	-3.0
Investment Growth	7.6	-7.7	3.6	-9.8	-25.6	-20.0
<i>External Economy (\$ Millions)</i>						
Hard-currency Trade Balance	36	494.8	539.7	944.8	-1,222	-450
Current Account Balance	-876	-807	-1,437	127	267	1,000
Gross Foreign Debt	19,592	19,602	20,390	21,270	22,657	22,500
Debt Service/Exports	--	--	52%	57%	30%	N/A

Sources: Hungarian Statistical Yearbook 1990; Hungarian National Bank; Government estimates; Monthly Statistical Statement #3/4, 1993; Business International Country Report, quarterly update, 01,1993.

³⁶ 528 Bankruptcies were filed in 1991, prior to the enactment of the *Bankruptcy Act* in January of 1992. It is estimated that over 3,400 cases were filed in the first three months of 1992 and approximately 3,540 in April alone making a total of almost 7,000 cases in the first four months of 1992.

³⁷ For an overview of the main economic indicators for 1987 to 1992 see Exhibit IV-1.

Trends over the past three years have shown the levels of non-government investment has growing substantially. Year end 1992 government statistics showed a decrease in total investment outlays of 20% while private investment outlays grew by 10.1% over the same period. Estimated investment for the first seven months of 1992 was 123.2 billion forints, or approximately US \$1.48 billion.

Inflation

One of the immediate results of the transformation to a market economy has been inflation, caused by a gradual elimination of price controls and the subsequent adjustment to world market prices. Twelve month inflation peaked in June 1991 at 38.6% and then fell continuously to 20.1% in July of 1992. Inflation of consumer prices for the twelve month period ended December 1992 stood at 21.6%, according to the Hungarian Central Statistics Office. This is a low figure when compared to other transforming countries but compared to an average of 4%-5% for most West European countries it is extremely high.

Inflation has had a profound effect on the economy and on the investment environment. Prices have increased more rapidly than salaries, resulting in a decline in the real purchasing power of buyers. This has caused an unpredictable market for goods and in some cases restricted manufacturers' ability to demand higher prices for consumer goods. Meanwhile, new taxes, particularly the value-added and personal income tax introduced as early as 1988, have kept disposable income levels down.

High inflation has also led to nominal borrowing rates that are too high to attract

entrepreneurial borrowers. According to the Hungarian National Bank, 1992 interest rates were between 20% and 25%. While these rates may be considered low when inflation rates of 20-25% are factored in, when compared to international rates and the potential rates of return for investments the bank rates are high. Against this the potential investor must achieve a desired real return which must be comparably high when country risks are factored in. It is the emerging consensus about risks and returns in Hungary's investment community that high real rates of return will be required to induce investment in the privatization process.

Inflation has further lead to great difficulties in raising credit and capital domestically and to discourage portfolio type domestic investment. With bank interest rates of over 25%, potential investments must have an expected return of 28-30% to make them attractive to investors. While the government recognizes such problems with domestic investment, the problem lies in the fact that any policy designed to increase available credit domestically would run counter to the anti-inflationary policy of the government.

In addition to this, the effects of Hungary's inflationary level have not been equal in all segments of the economy. In some cases, firms have faced drastic increases in the costs of inputs to production but have been unable to pass those increases on to the consumer. This is particularly true for firms which export a large portion of their production and face set prices in international markets.

Debt, the IMF, and Fiscal Policy

Hungary's international debt is the largest per capita in Eastern Europe. While the government has thus far been able to keep this debt under control and its trade surplus has been sufficient to cover interest payments, its fiscal policy and budgetary options are severely limited and its debt service to export ratio continues to decrease.

The budget deficit ballooned to HUF 160.4 billion at the end of October 1992, representing a revenue shortfall of 20.7% of total expenditures of HUF 775.2 billion. This deficit was caused by the government's failure to attain aggressive growth and production targets as well as unforeseen increases of HUF 24 billion in unemployment benefits. This has put increased pressure on the Hungarian government, as a tight monetary policy and balanced budgets are priorities of the International Monetary Fund (IMF).

Currency Devaluations and Non-Convertibility

While some concessions have been made for foreign investors and export/import companies, the Hungarian forint, unlike the Polish, Czech, and Russian currencies, remains officially non-convertible and is not traded internationally³⁸. The currency has been devalued repeatedly against major Western currencies in recent years and is expected to be devalued further in the next year with the move towards convertibility. This exchange rate uncertainty in itself must be considered as a risk, particularly to

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³⁸ Legislation has made the currency effectively convertible for international companies allowing for repatriation of profits in the companies home currency and for import/export trading.

foreign investors.

The Hungarian governments foreign exchange policy, aimed at increasing confidence in the forint and to encourage Hungarians to hold forint, not hard currency, has not been favourable to exporters. Devaluations of the forint have not kept up with inflation leading to an effective decrease in the revenues to exporters. For example, the January 7 and November 8, 1991 devaluations of the Forint resulted in a composite 15.7% devaluation for 1991 according to the Hungarian National Bank. During the same period, inflation of consumer prices was consistently above 30% annually.

Trade & The Loss of Traditional Markets

The structure of Hungarian trade, both domestically and internationally, has changed dramatically over the past three years. *Domestically*, many traditional buyers, are currently encountering severe financial difficulties and established distribution networks have vanished. Fresh demand is coming in the form of new, small enterprises who are more numerous and tend to buy in smaller quantities. These changes cause several difficulties for SOEs who have relied on established secure buyers and thus have never had the need for effective marketing. The SOE faces the need for a more sophisticated sales and distribution network as well as changes in packaging to accommodate smaller orders. Further to this the SOE must deal with the fact that these new buyers tend to pay in cash. Therefore it is necessary to establish an effective reporting system to regulate payable and receivables. The SOE can no longer rely on a balancing effect between its accounts receivable from one SOE and its accounts payable

to another. As one observer in the Hungarian privatization process commented:

When a company was in real trouble and the manager had friends in supplier companies or in customer companies, the payables for supplies would suddenly diminish or sales orders would magically increase - nothing really happened, but a trail of paper was created (Toltzman, 1992/93: 25).

While this situation is obviously an extreme, it is indicative of a need for changes in the system as a result of the changes in the domestic trading system. Finally, Hungarian companies also face dramatic increases in domestic competition from both foreign competitors which are enjoying freer access to the market due to trade reforms and from new Hungarian competitors.

Internationally, the single most drastic result of the reforms in Eastern Europe has been the loss of traditional trade ties between the former COMECON nations. It is estimated that the direct cost to Hungary of the shift to market prices caused by the collapse of the COMECON is as high as USD 1.9 billion or 6% of GDP (EBRD, 1992:18). The end of the COMECON meant not only the loss of subsidized energy from Moscow but also the loss of the most important markets for the majority of SOEs³⁹.

in Hungary in 1988 and 1989, we saw a gradual shift of about 5% from exports to the East to exports to the West. By 1990, some companies lost 50 to 100% of their sales to the East and were not able to quickly compensate with sales to the West without greater knowledge of Western marketing (Toltzman, 1992/93: 21)

In volume terms, Hungarian exports to the former USSR decreased by 52% between September 1990 and September 1991. In dollar terms Hungary saw hard currency

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³⁹ While 1992 has brought an end to the decrease in trade between these nations, trade levels remain significantly lower than pre-1990 levels and trade with these nations remains riddled with difficulties arising in ensuring payment.

exports to the former USSR drop from over \$1 billion to \$500 million over the same time period (BEE 09/09/91: 289).

Trade with the EC has increased from approximately 35% of all trade in 1990 to over 48% by mid-1992. Preliminary 1992 year-end statistics put EC trade at greater than 50% of total international trade. This increase has played an integral part in the improvement of Hungary's external trade balance and balance of payments position. Statistics show an overall trade surplus of \$130 million for the first six months of 1992 and it is expected that, for the first time, the balance of payments surplus will be greater than the interest payments on the national debt. 1992 also brought an end to the drop in trade with the former COMECON nations, however, levels remain far below pre-1990. The current trend for increased trade particularly with the new Commonwealth of Independent States which may prove to be riddled with more difficulties at this point than the potential benefits of access to the market. The uncertainty of trade with these nations, particularly in the areas of receiving payment, means that it is not necessarily a most desirable buyer.

Unemployment

Unemployment in Hungary has increased dramatically, resulting from plant closures and restructuring measures carried out since the introduction of an austerity program in 1987. By October 1992, the official reported rate had reached 11.6%, representing 627,000 unemployed. Of these, 450,000 were receiving unemployment benefits. These figures represent one of the most daunting aspects of the economic

problems currently facing the Hungarian government today. In November 1991, an agreement was reached at a meeting of the National Interest Co-ordination Council to increase the amount paid by employers and employees to support Social Security expenditures. As a result, employers now pay 7% of their gross payroll, and employees now pay 2% of their gross wages to fund social security expenditures.

POLITICAL SYSTEM & STABILITY

Until 1989 Hungary had a socialist, centrally planned economy in which state owned enterprises accounted for approximately 90% of the total output. Politically this was accompanied by a highly centralized communist government which, while being one of the most progressive in the East in terms introducing limited economic reforms and allowing some civil freedoms, essentially took its lead from Moscow.

Unlike some of the other countries in Eastern Europe, Hungary's recent political changes did not stem from a popular uprising but were negotiated. "A peaceful revolution from above" (Bigler, 1992). The process began with the May 1988 ouster of the Communist Party's General Secretary, Janos Kadar, whose 32 year reign began with the failed 1956 revolution. In June 1989 the leadership of the Hungarian Socialist Workers party announced that it was willing to negotiate with opposition groups. The purpose of the negotiations were to "establish conditions for contested elections, competitive political parties, and parliamentary governance" (Stark, 1991: 335). This marked the beginning of roundtable negotiations on political reforms which encompassed

more than three months of intensive negotiations and established the new 'rules of the political game'. Discussions evolved around "a new Constitution, registration of political organizations, election procedures, the mass media, and the disposition of the coercive apparatus of the state" (Stark, 1991: 362). The outcome of the roundtable negotiations was a democratic, multi-party, political system and "institutions of a European-type based on the rule of law" (HMR, 1991/02-03:3).

Negotiations produced a transitional constitution which amended approximately 90% of the 1949 constitution brought in by the communist party. After the 1990 national elections, an entirely new constitution was drawn up and adopted. Under the terms of this constitution the Hungarian Republic is an independent state based on the rule of law and dedicated to a multi-party system, parliamentary democracy, and the social market economy. The powerful Presidential Council was abolished and in its place a popularly elected presidency with more limited powers was created. The supreme organ of state power in the new Hungarian system is Parliament which is made up of elected persons, or popular representation. Members are elected by a system of proportional representation for four-year terms. Power to adopt or amend the constitution or other laws lies with parliament which also elects the State President, the council of Ministers, the Members of the Constitutional Court, etc.

The State president, Arpad Goncz, is the head of state and has considerable powers other than just ceremonial. He is elected directly by the public for a four-year term, renewable once. He is Commander and Chief of the armed forces and is authorized to call national and regional elections as well as to initiate referendums. The

Council of Ministers, under the chairmanship of the chief executive or prime minister, may issue decrees on matters within its competence provided they do not conflict with laws passed by Parliament. Its members are elected by parliament and its activities are subject to parliamentary control.

From 1988 until the 1990 elections 85 new political parties began to function in Hungary. Of these, 65 were actually registered but only 12 qualified to enter the 1990 elections (HMR, 1991/02-03). Of these 12, six ended up in parliament after the elections held March 25th and April 18th, 1990. Parliament held its first meeting May 2nd and received its mandate on May 23rd, 1990. From the results of the elections it has been estimated that only 12% of the total electorate was not represented. That is to say that the parties who did not receive seats in parliament represented only 12% of the total voters. This is a strong indicator of a relatively stable and representative government.

While the Hungarian political arena hosts many parties, according to most sources there are primarily three 'political nuclei' (ibid). First is the national conservative Christian Political centre based on acceptance of traditional values. This group includes the Hungarian Democratic Forum which won the majority of parliamentary seats in the first election, the Independent Shareholders party, and the Christian Democratic Peoples party. The second nuclei includes the social-liberal polarity which includes the main opposition party, the Alliance of Free Democrats, and the Alliance of Young Democrats. Finally, on the left, there is the Hungarian Socialist Party which is the regenerated reform-communist group. As is pointed out in a survey carried out by The Economist

on the situation in Eastern Europe in 1992:

The ... parties of Hungary... are probably closer on most areas of policy than Britain's two main parties... All support full membership in the European Community, currency convertibility, and privatization" (Economist, 03/13/93: Survey 3)

The primary differences between the Hungarian parties and their policies came in the relative importance of these issues, their sequence in the reform process, and the pace of reform.

In the elections of March and April 1990, the Hungarian Democratic Forum emerged as the strongest parliamentary party with a majority great enough that no two parties could band together to defeat it. The leader of the party, József Antall became prime minister and Istvan Csurka became deputy chairman of the ruling party. Prime Minister József Antall formed a coalition government with two smaller conservative parties, the Independent Smallholders Party and the Christian Democrats. The Antall government favoured gradual measures aimed at implementing Hungary's transitions to a market economy.

There were relatively few scandals during the party's first two years in power. It created one of the most stable governments in the newly emerging Eastern nations. Hungary is the only country in the region to have had only one election since 1989 and appears to show strong dedication to a stable government.

In 1992, opponents of market reform protested and gathered signatures to petition the government demanding that a referendum be held aimed at advancing the date of the next elections. The Hungarian constitutional court struck down the petition stating that: "a referendum cannot dissolve parliament and that elections are higher than referendums"

(Economist, 03/13/92: Survey 4). Interestingly, all of the political parties supported this decision. Despite the fact that the opposition parties would stand to gain the most, they understood the need for stable democratic institutions and predictable and consistent terms of office. This demonstrates the strong dedication of all parties in the political arena to a stable political environment.

Controversy surrounding the Antall government have tended to evolve primarily around the issues of the pace of privatization and reform, the use of revenues, and nationalist tendencies. One source observed that:

many pessimists state that it is impossible to pursue economic reform and democracy simultaneously and the governments will ultimately have to choose against democracy turning to either an authoritarian government, a challenge from the nationalist right, or a return of communists (Economist 13/03/93: Survey 4).

When this threat to democracy is considered in the Hungarian context, all three possible outcomes have been seen to some degree during the initial stages of transition but appear to have been overcome with democracy remaining relatively intact. There has been some evidence of an authoritarian leadership style in the ruling party's activities. However, the party remains dedicated to democracy and there is no evidence of attempts to circumvent the democratic process. It appears that such measures have been used only as a last resort to get necessary reforms through.

The possibility of the return of the communist party in Hungary is not strong since, without a real revolution in Hungary, the current parties reflect many of the communist party policies and the membership of the current government includes several

former communist party members⁴⁰. The Hungarian communist party has always tended to be pro-market, pro-competition and pro-reform.

The one possible outcome which has been a strong thorn in the side of the current government has been from the nationalist right. Nationalist tendencies are strong, for Hungarians who are a proud nationalistic people. One example of such feelings which in the end caused quite a scandal for the government, came from the Deputy Chairman of the ruling party, Istvan Csurka:

In the summer of 1992, Csurka,... raised the banner by issuing dire warnings that a Communist-Jewish-Liberal-Media-International-Capitalist ... conspiracy was strangling the Hungarian national at rebirth. He even called for Hungarian Lebensraum using the Hungarian equivalent of the German word, meaning room to live, used by Hitler to justify aggression. ... Six months later Mr. Csurka found himself out-manoeuvred by the prime minister at a congress of the party. Mr Antall nailed his and his party's colours firmly to the mast of modernization and compelled the MDF [party] to choose between him and Mr Csurka. Mr Csurka won three of the 20 seats on the party's ruling council (Economist 03/13/93: Survey 4).

Connected with the issue of nationalism is the violence against minorities in Hungary (primarily the Gypsies). The government has been slow in responding to ethnic violence. While this has not been as major an issue in Hungary as in other countries, particularly Germany, it has caused some problems and visible ethnic minorities in Hungary live in a certain amount of fear.

Despite these concerns, the political situation in Hungary is stable relative to its neighbours and does not cause great concerns to foreign investors. All parties in the political arena recognize a need for FDI and privatization. It is only the degree and

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⁴⁰ This is a common complaint of Hungarians that the government has not really changed only the name has.

speed of reforms which are areas of debate. On the primary issues relevant to the MNE considering the investment decision, Hungary represents one of the more attractive political environments.

Government Attitudes towards Foreign Direct Investment

The Hungarian government was one of the first of the former socialist countries to extend a welcome hand to foreign investment and the economy has remained one of the most open in the area. The government has introduced over time many tax breaks and special subsidies aimed at attracting investment.

The country was the first to guarantee the right of foreign investors and since then the legislation governing foreign direct investment has continued in that same light. Under the *Company Act* of 1988, any discrimination between foreign and international companies was eliminated and subsequent tax legislation has included tax breaks specifically for companies with foreign participation⁴¹. Additionally the government has created custom free zones, to be declared in areas where MNEs are interested in investing and there are special financial subsidies for operations of areas deemed to be less developed by the government. While most tax advantages are automatic, the majority of government subsidies are not. They are the result of either negotiations between the MNE and the government agency responsible or from tender processes.

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⁴¹ See Appendix E for a discussion of the Act.

LEGISLATIVE ENVIRONMENT

As a result of Hungary's tendencies toward economic reform prior to the 1980s, the country was able to boast the most advanced legislative framework, of all the former socialist countries, going into the transition. As early as 1972, Hungary drafted legislation allowing for the formation of international joint ventures with foreign participation and protecting the rights of foreign investors. This legislation has been amended significantly since then, allowing for greater freedoms to investors. Appendix E provides an overview of the legislation and its subsequent amendments as well as brief descriptions of some of the other more important legislation passed in the early stages of transition.

Other legislation important to the MNE considering investing in Hungary includes:

Company Act of 1988 governing the establishment of different forms of private legal business entities. It sets out the rights of Hungarian citizens and corporate entities to form such businesses and eliminates any discriminations between Hungarian and foreign entities. This act set the stage for allowing both the formation of new wholly owned private companies, and for the privatization of existing companies

Privatization legislation governing the establishment of controls on the disposition of state assets and which led to the formation of the State Property Agency. The legislation includes: the *Transformation Law (1989)*; the *Law on Protection of State Assets (1990)*; and the *Law on the State Property Agency (1990)*; and *Property Policy Directives*, as well as their amendments.

Securities Law (1990), governing the re-establishment of the stock market.

Bankruptcy Act passed in 1991 which outlines two alternative avenues for defaulting debtors: Reorganization similar to the US concept known as Chapter 11; and liquidation.

Law on Accounting (1990) which governs the conversion of the official accounting system to meet Western standards.

Competition Act (1990) governing the prohibition of unfair market practices and misleading advertising or unfair acquisition and use of business secrets.

All of these regulations have created what is a relatively stable legislative environment and the government appears to remain dedicated to the creation of a solid legislative framework comparable to Western standards. There remains, however, many areas where new legislation is necessary as the existing framework does not deal with the problems adequately. Those include:

Land and real estate. The development of efficient land markets suffers from inaccurate land registration and an underdeveloped legal and financial system. There is no system in place to deal with collateral and mortgages and it is essentially impossible to evict in the situation of default both on rental and on mortgage payments. The zoning system is outdated and the regulatory structure is not in place. Sever restrictions on foreigners owning land (UN, 1992:45).

Patent and intellectual property protection legislation is generally seen as better than other East European countries, but it lacks the means for investigation and enforcement of the law.

Environmental legislation meets international standards with respect to environmental standards, however, there are no clear procedures for implementation and penalties,

Contract Law which is currently governed by sections of the 1959 code designed for small, non-commercial private transactions.

Problems have also arisen from the fact that legislation has been passed quickly and often without consideration of all the possible ramifications. Lobby groups have been slow to develop and there is little opportunity for the people affected by the legislation to voice their opinions. The regulatory framework for controlling and implementing legislation often cannot keep up with the pace of legislation being passed.

The people most affected by new laws may be initially unaware due to problems in communications and interpretations of legislations. Therefore, while the legislation may be in place, the implementation may not be and the people either do not know of the legislation or may not understand its meaning.

ECOLOGICAL FACTORS

While Hungary has had several environmental movements in the past which have, in some cases, lead to legislation and the setting of environmental standards, it was not until 1976 that a comprehensive environmental protection act was passed. Even then the situation was not improved due to ineffective implementation and enforcement of the legislation. This was primarily due to limited funding and a lack of environmental consciousness and commitment on the part of communist regimes. Socialism saw the rise of an awkward situation, leading to little or no action, where the state was required to punish itself as the owner of the polluting agents.

Since the political reforms of 1989, environmental awareness in Hungary has increased resulting in pressure on the government to draft a new comprehensive environment act. Unfortunately, political priorities such as the dictates of economic reforms and rising unemployment have meant that environmental issues are simply not addressed or are left until the end of the legislative session. The environmental legislation which was promised for the end of 1992 is not expected until the end of 1993. The new government remains even more strapped for resources than its predecessor,

meaning that even if an act were passed its' implementation and enforcement necessarily would be limited by a lack of funding.

This lax attitude toward the environment, coupled with the unbalanced nature of industrial development of Hungary due to the Socialist economic development model, has resulted in accentuated environmental problems. These include: air pollution, due to antiquated automobiles; sewage and waste management difficulties, due to overpopulation in rural areas; and the more serious problems of soil and water contamination. Pollution and contamination in Hungary may stem not only from the mismanagement of the communist era but also from earlier activities such as World War II allied bombing of industrial sites which caused the release of vast quantities of chemicals into the soil, much of which remains.

In the majority of situations, industrial site contamination does not constitute a major health hazard, because the pollutants are non-toxic and leaks do not extend beyond the barriers of the site. Other cases, however, where chemicals such as chlorinated hydrocarbons are involved, the situation is more worrisome not only because the chemicals are highly toxic, but also because they tend to flow off site into the ground water.

Ecological Situation in Hungary

Air pollution is considered by experts to be Hungary's most pressing pollution problem with greater than 50% of the country's population living in areas considered permanently polluted. Much of this pollution is imported from neighbouring countries

and about 40% is a direct result of exhaust fumes.

Pollution of the country's water system is another major issue in Hungary. 95% of Hungary's big rivers originate abroad and thus import contamination from foreign sources. While the Danube is considered to be less polluted than other rivers in Europe, it still poses a severe environmental problem in Hungary. One of the most important issues was the controversy over the Gabčíkovo Hydroelectric Dam built by neighbouring Slovakia. Hungarians feared that the dam and the resulting rise in the water level would result in greater water traffic and contamination in the river.

Contamination of the country's ground-water resulting from extensive use of fertilizers in agriculture and a lack of proper waste disposal and water purification systems is also an issue. This problem is accentuated by the fact that Hungary is located in the Carpathian basin, producing a tendency for the water to hold pollutants rather than disperse them.

Soil pollution resulting from improper disposal of solid and chemical waste as well as over-working of agricultural land is another major issue which is particularly important to investors. There is evidence of a lack of effective containment of solid waste at designated waste dump areas as well as insufficient dumping facilities to handle the needs of larger metropolitan areas. As mentioned above there is evidence of soil contamination from oil, gas, and toxic waste spills. Finally, in terms of agricultural land, which accounts for 88% of the country's land area, there is evidence of not only shrinking land area but also decreasing soil quality resulting from overworking of the lands.

Hungarian Governmental Policy

The governments response to environmental problems has been: "the polluter pays". But the catch is that when an investor purchase an enterprise or a plot of land he/she also inherits this liability for clean up. As George Hollo, an advisor at the Hungarian agency for privatization, has been noted to say: "Sales are as is". The government simply will not pay for environmental cleanup, primarily because it has no money to do so⁴².

The government does require that an environmental assessment be performed as part of the transformation of any state-owned enterprise and that this assessment be included in the investment memorandum. This memorandum is then used by potential investors as a basis for determining a purchase bid price. Discrepancies between the cost of cleanup as estimated by the environmental assessment and included in the investment memorandum and the actual costs may in some cases be compensated by the government. The government will set a range within which it will cover any costs over and above those outlined in the memorandum⁴³.

Major Ecological Cases

Due to the lack of attention to environmental issues in Hungary many situations have been allowed to grow out of control. One relatively publicized example was the mammoth leaks of mercury from a plastics factory in Miskolc. The government finally

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⁴² A paraphrase of a comment by an official at Hungary's environmental agency found in an article written by Bob Hagardy in the WSJE, Apr. 8, 1992, page 9.

⁴³ Information sourced from interview with director at the SPA.

insisted that cleaner methods be introduced at the plant, but cleanup measures were postponed since no immediate health risk was found. The Metallochemia case also had serious ecological ramifications. In the end, the government closed down the plant, which was not only the country's only car battery recycling plant, but also one of the largest producers of toxic waste. The most publicized and largest privatization case which also involved environmental issues was the sale of the LEHEL refrigerator company to the Swedish company, Electrolux (see case study in Chapters VII and VIII).

CONCLUSIONS: Assessment of the Investment Environment

Through an assessment of the Hungarian investment factors described above it can be seen that the environment is unstable and there exists many negative factors which would act as deterrents to investment and add to the risks associated with a venture there. Exhibit III-4 provides an assessment of the Hungarian investment factors described above. The positive and negative trends of each factor are summarized providing a conclusions of the overall picture of the investment environment.

MNEs take each of these negatives into consideration and seek to circumvent them or render them neutral. Those negatives which cannot be overcome are weighed against the positive factors and the perceived benefits of the deal to determine its viability.

Exhibit III-4 INVESTMENT ENVIRONMENT		
	Positive Factors	Negative Factors
Factor Endowments <i>Labour</i> <i>Capital</i>	• Highly skilled and relatively cheap labour. • Capital market established in 1990.	• Low productivity and high social costs and taxes decrease cost benefits. • Domestic capital not available in the system. Need to mobilize.
<i>Production Costs</i> <i>Energy</i> <i>Technology</i> <i>Market Size/Income</i> <i>Managerial Skills</i>	• Relatively low cost production expansion. • Strong R&D capabilities, relatively good quality technology. • Ideal location for springboard for both East and Western Europe as well as the middle East.	• Low productivity and efficiency, poor quality. • Loss of low cost energy from former USSR. Need to import energy. High cost. • Yesterday's technology with poor maintenance. Lack of computerization. • Small domestic market with low income. • Lack of know-how in most managerial skills -marketing, (western) accounting, computers, human resources.
Infrastructure <i>Banking & Finance</i> <i>Telecommunication</i> <i>Transportation & Utilities</i>	• Two-tiered banking system in place which is on the surface a good system • Road systems in major cities relatively good and public transit system excellent in major cities as well as between major cities.	• In practice many frustrations since banks not oriented towards private customer service but rather towards larger government transactions. • Telephone system is out of date and there is a shortage of lines. • Many frustrations with mis-connections. • Road systems in rural areas not adequate.

Exhibit III-4
INVESTMENT ENVIRONMENT

	Positive Factors	Negative Factors
Cultural Factors <i>Culture & Ethnicity</i> <i>Language</i>	• Very European culture and primarily one ethnic group. Little ethnic strife. • Many Hungarian Nationals who left in 1956 with language skills and acquired Western business culture. • Hungarians very willing to learn English.	• Cultural problems with nationalistic pride and ideals left over from communism. • Difficult language to learn, unrelated to any other languages and not widely spoken.
<i>Business Customs & Work Ethic</i> <i>Political & Trade Ties</i> <i>Geographical Location</i>	• Historic ties to Austria. • Dedicated to trade ties with EC and former CMEA countries. • Excellent central location.	• Low productivity and poor worker attitudes. • Strong resistance to change. • Great distrust and lack of communication. • Lack of initiative, incentive, and innovation. • Unwillingness to take responsibility and make decisions. • Ethnic strife and civil wars in neighbouring countries.
Availability of Information	• Much information also available in English	• Difficult to obtain correct statistics which represent the true situation. • Problems with confidentiality and an unwillingness to provide information. • People tend to tailor information as to fit what the seeker wants to know rather than reality.
Economic Factors	• Gradual reforms over many years lead to a favourable starting point and a more stable environment for reform. • Economic situation appears to be improving by late 1992, can see the light at the end of the tunnel.	• Since in transition, inherently instable environment, high inflation, large external debt restricting fiscal and monetary policy, loss of traditional markets, unemployment, non-convertible currency, etc. • World wide recession has also affected Hungary and put economy in further downward spiral.

Exhibit III-4
INVESTMENT ENVIRONMENT

	Positive Factors	Negative Factors
Political Factors Government Attitudes Towards FDI	• Democratic system with a strong hold on government. Relatively stable and few scandals. • Government always extended welcome hand to foreigners. • Subsidies and tax breaks set up for foreign companies.	• Concepts of democracy still new and party in power shows some tendencies towards the old system of more dictatorial leadership and patronage. • Nationalistic tendencies. • Problems dealing with some government individuals.
Legislative Factors	• On the surface Hungary boasts one of the most advanced legal frameworks in Eastern Europe. • Legislature appears dedicated to creation of an effective legislative system.	• In practice the system is riddled with problems. • Legislation is made in haste leading to mistakes and a lack of consideration of all possible factors. • Lack of communication with all interest groups when legislation is drafted. • Uncertainty due to a lack of effective explanation and communication of finished legislation. • Administrative system not set up to implement legislation.
Ecological Factors	• Governmental awareness to the extent that clean up costs are considered when determining purchase price or valuation of SOE	• Severe ecological situation due to 40 yrs of apathy and little or no action in terms of clean up.

CHAPTER IV. PRIVATIZATION IN HUNGARY

This chapter provides an overview of privatization in Hungary as it is relevant to the investor considering the acquisition of a State Owned Enterprise. The chapter is divided into three sections. The first discusses the main issues which lead up to the formation of the Hungarian program. The second section provides an assessment of the government agency responsible for privatization in Hungary, the State Property Agency (SPA). The final section provides a discussion of the primary concerns of foreign investors with regards to the privatization process and dealing with the SPA.

ISSUES SURROUNDING PRIVATIZATION

Historical Ownership Reforms

Some reforms towards decentralization of ownership in Hungary were implemented under the 1968 New Economic Mechanism (NEM) and subsequent economic reform legislations. However these reforms were limited and, as most analysts agree, not entirely effective. During the 1960s and 1970s the people working on state farms and agricultural cooperatives were allowed to use their household plots for private activities. In the 1970s and 1980s tenants were given opportunities to buy their state-owned apartments at between 15% to 30% of market value. Also during this time period, auctions were held both on large scale farms allowing employees to bid for sub-contracted responsibilities, and in the cities to distribute leases for restaurants and retail shops (OECD, 1991). In the late 1970s and early 1980s foreign participation as minority

partners in joint ventures was encouraged. In the mid 1980s economic working groups in SOEs were set up designed to allow individuals to accept "after hours" work for competitively determined wages. In 1983 many state ownership rights were delegated to *enterprise councils* in approximately 70% of SOEs.

These reforms helped place Hungary in a good position for the transition to a market economy, but they did not succeed in eliminating shortages and inefficiencies in production. The need for a radical reform of ownership structure has been well documented by such authors as Stark (1990), ("Privatization in Hungary: From Plan to Market or From Plan to Clan"); Milanovic (1991), ("Privatization in Post-communist societies"); Włodzimierz & Laski (1990), (From Marx to Market); and Kornai (1990), ("Socialist Transformation and Privatization: Shifting from a Socialist System"). All of these authors analyzed the experience of prior reform efforts in the former socialist economies and concluded that the dominance of the public or state ownership is incompatible with market coordination. They argued that a change in the ownership structure of the economy, involving a decrease in the extent of state control and an increase in private sector activities is necessary for the transformation to a market economy.

The Extent of Public Ownership

There were some 2,200 state-owned enterprises in Hungary at the beginning of the reform process with a book value of approximately USD 22.5 billion (HUF 1,800 billion). Of these, 350 were classified as large scale business - employing five to ten

thousand people and/or having revenues of over USD 25 million (HUF 2 billion). 600 were classified as small businesses - 200 to 500 employees and revenues of US \$63,000 to US \$2.5 million (5 - 200 million forint) - and the remaining 1,250 classified as medium size (SPA2, 1992: 88).

In an attempt to determine the proportion of those enterprises or their assets that should be maintained in state hands the Hungarian authorities drew up a privatization exemption list which limited the amount of private ownership in some entities of 'strategic national importance'. Enterprises have been categorized as 100% state ownership, 51% state ownership guaranteeing the right to involvement in strategic decision-making; and 51% national ownership (state and private) thus limiting foreign ownership⁴⁴.

The issue of Ownership Rights

In Hungary it was called 'Spontaneous Privatization'⁴⁵, in Poland; 'Nomenklatura Privatization'. The outcome was the same: public outcry over what was believed to be an unjust situation where former party apparatchik were able to gain from

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Ministries have classified 105 of the 2,200 SOEs available in Hungary as strategically important and those which must remain under government control in the longer term (SPA2, 1992: 88). Along with this the government has established exemption lists governing the extent of foreign investment allowed in given SOEs. While initially these lists were seen as restrictive by foreign investors, as time has passed they have become less and less extensive and as one source noted, the lists actually facilitated investments as it gave SPA case officers and company councils some direction in their negotiations.

⁴⁵ This is not to be confused with the controlled spontaneous or company initiated privatization which has become one of the primary methods for privatization in Hungary since the formation of the SPA in May 1990.

the positions they held under the former regime⁴⁶. The profits from the sale of state assets did not go into what the people believed were the "right pockets", and these sales also took place at less than a fair return for the assets allowing the buyers to profit. This allowed foreigners and people who had money under the old system to gain from the transformation at the expense of the state and the general public. It was particularly controversial in cases of foreign buyers since, as management was eager to gain foreign currency, assets were often sold at unreasonably low prices. The perception was that foreigners were "stealing assets".

In Hungary scandals surrounding cases such as HungaroHotel and Apitz led to cries for equality and representation of state or employee interests. It became obvious, early in the privatization process, that the ambiguity of ownership right had to be eliminated. It was necessary to establish formally who had ownership rights and thus had the right to sell or 'privatize' the assets. Ownership was argued to be shared at least in part by: the workers, management and enterprise councils of the enterprise; the ministries who founded the enterprise; and the general public. That is not to mention the claims of former owners who had lost assets during the nationalization campaigns of the 1950s.

Workers and management asserted that they had ownership rights based on the belief that it had been their efforts that led the enterprises to grow into their present positions. This was particularly relevant for labour intensive sectors. The government's contrary argument lay in the fact that the establishment and survival of these enterprises

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⁴⁶ For a detailed discussion of this phenomenon as it pertains to Hungary see Milanovic (1991), Stark (1990), and Matolcsy (1990).

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MICROCOPY RESOLUTION TEST CHART
NATIONAL BUREAU OF STANDARDS
STANDARD REFERENCE MATERIAL 1010a
(ANSI and ISO TEST CHART No. 2)

depended largely on government subsidies and investment resources. *Enterprise councils* asserted that the decentralization of control which occurred in the mid-1980s when the councils were established gave them rights of ownership. This decentralization had the effect of making enterprises almost independent from the ministries and hence independent from the state.

The claims of *former owners* were based on the desire to return to the way things were prior to communism. Thus, the essence of the 're-privatization' argument was to return assets to those who suffered during the nationalization campaigns in the early stages of communism. The problems with re-privatization were that many people suffered losses as a result of communism which were not material assets. Also, to return assets would be next to impossible as over the years some assets have been destroyed while others may have been upgraded through state subsidies.

The Hungarian solution to the ownership issue was to legally confirm absolute state ownership while providing some form of compensation for the other actors who claimed ownership rights. Ironically this then required that the assets be re-nationalized before they could be privatized (Hollo, 1992). The Hungarian government adopted programs designed to provide compensation for employees, management, and enterprise councils in the form of Employee Stock Ownership Plans (ESOPs)⁴⁷. For compensation of former owners, in 1991 the Hungarian parliament approved the final version of the

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⁴⁷ The specific ESOP program depends on the form of the company, its ownership structure and its financial structure. In general, however, the plans involve either an allocation of shares to employees and management, the possibility for employees to purchase shares at a discounted price, &/or the granting of special credit to employees and management for the purposes of purchasing shares. See appendix B for a detailed description of the ESOP programs

Compensation Voucher Program. The purpose of this program was not only to provide compensation for losses but also to increase investor confidence which had been marred due to questions raised by ambiguous ownership rights. Through this legislation the government clearly outlined the rights of former owners, or their rightful heirs, with respect to nationalized property⁴⁸.

Control over Privatization

Tied in with the debate of ownership rights is that of control over the dispersal of state assets. In Hungary this became a debate of 'privatization from above' - where the state retained control of assets and privatization was centralized through a government agency- versus 'privatization from below' - where privatization was decentralized and control essentially lay with the enterprise council or management (Hollo, 1992:17).

Advocates of privatization from above generally cited the enormous uproar associated with the perceived unfairness of spontaneous privatization and argued that the rights of the state and of the people must be protected. As Kornai stated:

If privatization is not brought under public control its consequences will be merely private gain and not the public good (1991).

The counter argument was that bringing privatization under state control would simply produce another bureaucratic organization. The process would be slowed dramatically and the possibilities for corruption, instead of being decreased, could be increased. The advocates of privatization from below argued for importance of speed and rapid transition

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⁴⁸ For a detailed description of this program see appendix C

which they say is more important than the fear that some assets might be squandered. They pointed out that squandering was likely to take place at any rate (Stark, 1990).

Advocates of privatization from above responded to this by arguing that the new agency would be accountable to a new democratically elected parliament which would essentially eliminate the potential for corruption and that rapid transformation was likely to decrease prices and thus decrease potential revenues. Further, they argued that the opportunities to gain revenue from the privatization of state assets would be a 'once in a life time deal' which should not be given up (Stark, 1990).

The Hungarian solution was to opt for centrally controlled privatization from above. Privatization in Hungary is officially governed, and primarily takes place through a government agency, the State Property Agency which is designed to "exercise ownership rights over state assets in the course of reducing the state ownership of the economy" (Hollo, 1992: 17). The purpose of the State Property Agency, and the separate legal companies under its authority, is "the management and utilization of state assets with the aim of facilitating and regulating the privatization of state firms" (ibid). The agency represents the interests of the state in the privatization of the state sector. It is designed to ensure that the state gets a fair price for its assets and that the states interests are protected⁴⁹.

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⁴⁹ Further information on the functioning of the SPA and some of the problems faced in dealing with it are found later in this chapter.

The Pace of Privatization

The decision regarding the desired pace of privatization was one of the primary factors dictating the form and methods of privatization. Pace was also the root of the primary differences between the Hungarian reforms and that of the other Eastern European countries, in particular Poland's 'Big Bang'⁵⁰ model. The heart of this issue took the form of a debate between the free distribution of state assets and the sale of assets (Exhibit IV-1). For the former the primary goal was to complete the process as quickly as possible. For the latter it was to ensure a fair financial return.

Exhibit IV-1 Free Distribution versus Sale of Assets		
	Advantages	Disadvantages
Free Distribution	Egalitarianism Fast privatization Lack of domestic capital	Does not generate revenue Ownership dilution will not lead to changes in companies May be difficult to administer May not create real advantages of private ownership since no financial commitment
Sale	Possibility to attract strategic investors One time source of revenue to state Creates real sense of ownership and more likely to lead to changes in company	Difficulty in valuation of assets Difficult to find investors since lack of domestic capital

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⁵⁰ The views adopted in this model are primarily those advocated by Jeffery Sachs.

In Hungary the option of free distribution of shares was not considered a viable alternative. The debate evolved around different methods for selling assets and the speed at which they should be sold. Opposing views on this issue were held by the Blue Ribbon Commission⁵¹ and the famous Hungarian Economist Janos Kornai. According to the Blue Ribbon Commission's 1990 policy recommendation report on the transformation of the Hungarian Economy: "Although the full transformation will take time, a market economy should be created with all deliberate speed." The Commission recommended large sales and/or placements to institutional investors and a rapid development of financial intermediaries as well as a large role for distribution of shares to employees and the relative unlimited encouragement of foreign investment. Kornai argued that it was necessary to allow for the gradual, although accelerated, evolution of the private sector. He was strongly against institutional ownership and recommended a limited role for employee ownership schemes. Kornai recommended the encouragement of foreign direct investment but qualified this by calling for controls on such investment to ensure that the maximum possible benefits to Hungary are realized (1990).

Kornai's argument stemmed from the belief that privatization, defined as eliminating state ownership, was not sufficient to facilitate the transformation to a market economy. He saw the development of a strong private sector as the key. To Kornai, the essential point was that the market economy had to be based on the interaction of private actors who truly reacted to market factors. He believed that this could only be

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⁵¹ The Blue ribbon Commission was set up to debate and make recommendations regarding the transformation of the Hungarian economy to a free market. Members of the commission include prominent economists from Hungary and the world over.

developed gradually through a three stage evolution; from small entrepreneurs to medium-sized and then to large enterprises. To skip one of these stages, he argued, would mean that the benefits of 'privatization' would not be realized and the formation of a functioning market economy would not occur.

The Hungarian government considered options which lay between these two extremes. Debate evolved around; gradual centralized privatization which emphasized state control versus decentralized distribution where the government would be responsible only for the largest most profitable SOEs. The first option would involve the formation of a national property centre which would privatize companies with the help of state holding companies organized on a sectoral level. Under the second option the majority of companies would privatize themselves (Tozsde Kurir, 07/05/92). The outcome of the debate was a cross between these two. In initial stages the first view was most prevalent but centralized programs were abandoned as economic difficulties and decreases in standards of living lead to demands for faster privatization.

The specific timetable for privatization has also changed as the principle of gradual reform has been overridden by a necessity for speed. The government has extended it's deadline for the transformation of all SOEs into limited liability or shareholding companies from the end of 1992 to the end of 1993. The strategy for a decrease in the proportion of state property from 90% to 40% by the year 1994 has remained relatively untouched, but some sources have quoted the residual percentage at 50% rather than 40%. The ultimate goal was a decrease to approximately 30% by 1995, but again that deadline has been extended in some sources. Changes in the expected

timing of privatization have been more prevalent in the short term as deadlines are missed. For example, as one source noted in December 1990:

The Agency's [SPA] plan for 1991 is to pass 400 state enterprises wholly or partially to the private sector; 200 of them will be privatized on the initiative of the enterprises, 100 will be handed over by the property agency and the remaining 100 will be sold in response to approaches by would-be purchasers (Pesti Hirlap, 04/12/90).

While at the time this seemed to be a reasonable prediction it did not come to pass. During 1991 the SPA approved the transformation of 189 companies and further transformations were initiated in over 50% of SOEs (Hollo, 1992). Actual privatizations processed by the SPA in its first 18 months, ending in September 1991 was only 50, nowhere near the 400 target (SPA, 1992).

Foreign Investment Ownership

In general terms, almost all participants in the Hungarian reform debate agreed that some significant level of foreign direct ownership was desirable (Stark, 1991). Experience over the past 20 years regarding foreign participation in the socialist economies, has shown the benefits to an economy to be gained through involvement with foreign enterprises. Moreover, evidence demonstrated that the best way to ensure the greatest return from these links was to involve the investor in an equity arrangement where they had a direct interest in the viability of the project. Exhibit IV-2 outlines some of the arguments for and against foreign ownership.

Exhibit IV-2 Advantages and Disadvantages of Foreign Ownership		
	Advantages	Disadvantages
Foreign Investors	-Hard currency earnings needed to decrease large debt -Necessary to modernize industry -Need new technology, product, R&D, marketing & management know-how	-Foreign domination of the economy, lose national sovereignty -Unemployment expected to be worse and earlier
Domestic Owners	-Maintains national sovereignty -Less expected unemployment and not as early	-Sufficient capital not available -Need foreign know-how & technology -Doesn't help increase involvement in the international economy

According to the Ribbon Commission's report Action Program for Hungary in Transformation to Freedom and Prosperity: "Foreign investment is an important part of integrating Hungary into the international economy" (1990: 40). Additionally, FDI provides benefits to the domestic economy through the generation of new capital, employment and economic activities; through transfer of technology and know-how; and through access to foreign markets⁵². Therefore, in order to achieve the Hungarian governments goals in privatization foreign direct investment had to be allowed.

Kornai had a less enthusiastic view of foreign investment in the privatization of the economy but he too acknowledged the potential benefits of foreign investment. He

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⁵² The issue of FDI increasing export orientation is demonstrated well by Andras Intonai in his article "Liberalization and Foreign Direct Investment", in Koves & Marer's Foreign Economic Liberalization: Transformations in Socialist and Market Economies (1991). In the article the author provides a study of the results of 23 developing countries and concludes that on average every dollar of FDI results in two dollars of additional exports. The survey also showed that in general brownfield investments had higher export generation levels than greenfield.

stated that "part of Hungary's state wealth can be sold to foreign owners, but only to the extent compatible with the nations interests" (1990: 295). From here he went on to caution that "We must not sell Hungarian state owned property to foreign owners at just any price" (ibid).

Kornai's views pointed to the issue of restricting foreign investment in terms of the sector of the economy, the percentage of the nations wealth, or a percentage ownership in a given enterprise.

It may be worth placing an upper limit on the proportion of Hungarian state owned properties that foreigners may buy (Kornai, 1990: 296).

Kornai cited as a possible example the South Korean model where foreign investment is controlled by a Korea fund through which all foreign investment must flow.

The question here was one of national sovereignty and minimization of the effects of foreign interests on the economy while maximizing the opportunities for Hungarians and the benefits to the Hungarian economy. The proportion of foreign ownership in Hungary at the beginning of 1990 was approximately 2% of the country's industry. In many small west european countries this figure is about one third of the country's industry. Therefore, by international standards there was ample room for expansion of foreign ownership without risk to national sovereignty (Blue Ribbon, 1990: 41). However, while there was room for increased investment, it was important to remember that many of the industries in former Socialist states were monopoly industries and foreign investment in former monopoly SOEs may have had a greater effect on the economy than regular investments in competitive market economies.

Methodology of privatization

The privatization process in Hungary involved two steps, transformation of the SOE into a joint stock or limited liability company followed by the privatization of the transformed entity. In some cases these processes were carried out simultaneously and in other cases the SOE was transformed into a private corporation with the state being the sole shareholder⁵³ and subsequently private investors were sought. Apart from noted exceptions, at the point of transformation all property rights were transferred from the ministry or Enterprise Council to the SPA for privatization. Often this was a minor technicality, particularly where privatization was performed simultaneously with transformation, however in some cases this led to a change in the management of the company along with various restructuring efforts.

In the period from March 1990 to the end of 1992, the options available in terms of methods of privatization grew. As the true complexity of the privatization of the economy was realized the role and responsibilities of the SPA increased in terms of volume and scope (Hollo, 1992). The SPA went from being a controlling agency for company initiated (spontaneous) privatization to initiating privatization through various programs designed to speed up the process.

Despite the initial controversy and scandal surrounding 'spontaneous privatization', such *Company initiated (spontaneous) privatization* remained the most common in Hungary and, in fact, its frequency increased after the inception of the SPA controls. The new process was relatively simple with transformation and privatization

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⁵³ While the state is generally the 100% shareholder, in many cases some small percentage is also held by local governments according to allocations made by government.

being initiated by the company. State interference was generally limited to a controlling roll where the SPA acted as a representative of the state interests in negotiations surrounding the transformation and sale of the SOE. The SPA could also act as an advisor in some cases however this did not occur in the majority of cases.

In most of the major company initiated privatization cases during the early years, a foreign strategic investor was involved (SPA, 1992:5). In fact in the SPA's first 18 months of operations it was estimated that over 85% of privatizations involved foreign investors. The selection of foreign partners took place on the basis of either open or closed tenders and the main criteria for judging offers was said to be "the opportunities the prospective venture would create regarding the asset in question and the economy as a whole" (ibid). That was to say the ability of the venture to further the governments goals for the transformation of SOEs - to increase capital, improve technology, and secure long term market prospects.

The programs set up in Hungary to encourage privatization fell in to four categories:

- *Active privatization* where the SPA selects firms or industries and forces privatization;
- *Pre-privatization* tailored for the small and medium size enterprises in the retail, catering, and service sectors;
- *Investor Initiated privatization* designed to allow prospective investors to approach the SPA to initiate the sale of an enterprise; and
- *Self-privatization* which allows firms to privatize without SPA controls.

The purpose of these programs was to speed up the privatization process in Hungary, since company initiated privatization did not prove as effective as predicted, and to encourage investment particularly by foreign investors. The 'active' privatization

program included major cross-industry programs as well as several industry specific programs and also established an advisory, financial and investment network for privatization⁵⁴.

ASSESSMENT OF THE STATE PROPERTY AGENCY

Within the realm of privatization, the most important government department or agency which the potential investor must deal with is the State Property Agency. The interactions between the potential investor and the SPA have a profound effect on the viability of a given investment proposal and therefore the attitudes of the people in this agency towards FDI and foreign investors is crucial to this analysis⁵⁵. What follows is a overview of the SPA as perceived by foreign investors and consultants who had dealings with the SPA during the early years - May 1990 to December 1992 - followed by an assessment of the Strengths, Weaknesses, Opportunities, and Threats of the SPA.

Employment and Organizational Structure

The SPA was founded in 1990 with a staff of approximately 40 people who were dedicated to finding answers to the challenge privatization in Hungary created. The

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⁵⁴ See Appendix A for a full outline of the privatization programs set up by the SPA.

⁵⁵ It has been difficult, due to confidentiality and an inability to reach the right people, to ascertain directly from investors what the frustrations they have faced in their dealings with the SPA. As such the majority of the information in this section is based on interviews with several other actors in the privatization process such as investment and legal consultants. In some cases these opinions are supported by items mentioned in the press or academic papers.

small number of dedicated people was initially seen as a benefit since it would allow for flexibility. However, with a total of over 2,200 cases to process, the potential benefits of flexibility were outweighed by the problems of delays due to understaffing. Each SPA case officer had an average work load of over 20 cases which, by law, had to be processed within 30 days. Also, cases tended to be allocated according to numbers without any regard for variations in the degree of difficulty associated with each case⁴⁶. Cases could not be given the kind of attention they deserved and often were not processed on time.

Understaffing also lead to high employee turnover rates as workers suffered from burn out and were lured away by higher salaries and more prestigious positions in the private sector. There was a perception that the SPA was a training ground where people went to gain the experience and contacts required to function effectively in the private sector. High turnover led to problems with continuity not only between cases but also in the course of negotiations of one case. The SPA case officer responsible for a given case could change two or three times. The agency lacked any form of formal training and communications within the agency were almost non-existent. Case officers learned as they went and with high turnover, the number of inexperienced and unknowledgable people increased. Privatization of this scope was a new phenomenon and knowledgable experts willing to work for government wages were not available.

Hiring practices at the SPA have relied almost exclusively on nepotism or the 'old boy network'. This led to questions regarding whether the SPA was getting the best

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⁴⁶ This is according to an interview with an employee of the SPA.

people for the job and tended to leave a door open for corruption. While in general the SPA was considered to be above reproach with respect to corruption, one interviewee expressed the opinion that, one explanation for the high turnover rates was that the people at the SPA could easily be corrupted⁵⁷. The process for giving bonuses, which could mean up to double your salary, tended to depend more on how well you were liked by your supervisor than on actual performance. As in most Hungarian organizations, there was no system established for effective valuation of performance.

The organizational structure of the SPA, while small, was both inefficient and bureaucratic. All authority for decision-making rested in the hands of the managing director and responsibility for privatization cases was set up on a program rather than a sectoral or industrial basis. Under this structure there was no room for a case officer to become an expert in a particular industry. There was also a severe lack of communication within the SPA. There was no central information system or coordination between the activities of employees in any one section.

Political Influence and Control over Action of the SPA

In the initial negotiations surrounding the formation of the SPA, its political nature was thought to be a good point since it would be responsible to a democratically elected parliament rather than being a bureaucratic arm of the old system (Stark, 1991). In practice, however, this became a deterrent to the effective functioning of the SPA.

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⁵⁷ This opinion is not shared by others interviewed but it is interesting to note that the comment was made, and that it was made by a Hungarian who works with the SPA regularly on smaller privatizations designated for domestic investors.

Official political control over the SPA was realized both through the patronage appointments of members to the SPA's Board of Directors and through the limiting of power the SPA was allowed in Parliament. All privatization programs and cases had to be approved by the SPA's Board of Directors who were selected and appointed by Parliament. In Parliament, the SPA was subject to strong opposition from other ministries who wanted control over both the privatization process and its potential revenues. Particularly strong political infighting took place between the SPA and the Ministry of Finance.

In January 1991 Finance Minister Kupa criticized the slow pace of privatization. He tried to limit the powers of the SPA and to incorporate it into the Ministry of Finance (Tozsde Kurir, 14/11/91)

A Minister responsible for privatization was not appointed until November 1991 - almost one and a half years after the establishment of the SPA. Even then, it was a Minister without portfolio and had limited power in Parliament.

The effects of this political control on the functioning of the SPA were to create a situation of bureaucratic decision making, uncertainty and fear. Parliament was unable to set clear policies and guidelines which could keep up with the changing economic environment. In the words of George Hollo, an advisor to the SPA:

Parliament, by not accepting the 1991 Property Policy Directives, has instead prolonged the validity of the provisional directives of 1990 which fail to reflect the economic and political changes which have taken place. Therefore the SPA has no clear guidance from Parliament as to such issues as criteria for deciding cases, the extent of foreign participation, who should get revenues from privatization, etc. (Hollo, 1992).

The lack of official guidelines, left the employees of the SPA in an impossible situation. For privatization to continue, decisions had to be made regarding both individual cases

and new programs. However, the SPA did not have the political power to make those decisions. The result was a situation where employees feared making controversial decisions and what decision were made were based more on political goals than on sound business analysis. Further to this,

There was an inherent conflict of interest in the SPA's mission. The agency was set up to 'own' state assets long enough to stream line and reorganize them. Once the SPA had done this, it was to sell the firms to private bidders. But the SPA's 140-member team was simply not large enough to manage even one of these tasks (Tozsde Kurir, 14/11/91).

Parliament's early firing of the first managing director of the SPA gave the indication that opposition within the SPA to the political desires of parliament would be punishable by loss of employment. This fear to speak out against parliament was further enhanced by the employee bonus structure. The incentive was to go along with the decisions of the higher levels of in the hierarchy, the top of which was Parliament.

Hostile Attitudes of Employees

Due to the limited resources of the SPA, trust became a major factor in the privatization process. High case loads meant that it was necessary for case officers to rely on the advice of consultants. Therefore the ability to create a relationship of trust between the investor, or his consultant, and the case officer at the SPA became a key in negotiations. As one consultant interviewed stated:

You work on a case for months then go to the SPA case officer who has given it one day, if you are lucky. His ability to trust you and have confidence in your work is the primary factor since he can not effectively do the same kind of analysis the consultant does.

Unfortunately, most people interviewed felt that SPA employees had a hostile attitude towards outsiders leading to a lack of cooperation and a sense of distrust. While in any negotiation each party has different goals and often those goals are in conflict, it was perceived that SPA employees had an excessively conflictual attitude. There was also mention of power games being played by inexperienced SPA case officers trying to build their self-importance by playing games with potential investors. An SPA case officer holds a great deal of power in negotiations and cases have been reported of the officer abusing that power.

Interviewees commented on attitudes in the SPA which were stereotypical of those formed under the former regime. SPA personnel were inclined to dismiss new ideas saying "that is not the way we do things here". New and innovative ideas did not appear to be generated or encouraged. One interviewee pointed out there appeared to be a bureaucratic, ministry like mentality at the SPA. People were not willing to make decisions since if they didn't make decisions they couldn't be criticised. An obsession with secrecy and confidentiality was another characteristic mentioned. As one prominent legal consultant pointed out; "the one thing they are really good at doing efficiently at the SPA is to get a letter of confidentiality sent out immediately."

Another obsession referred to was with transparency and legitimacy. While this could be seen as a positive point since it has meant that there have been limited questions of corruption in the SPA, it also meant that the information demands of the SPA have been excessively high and the procedure too long and costly. Demands in terms of price, information (valuations), and bid tenders have all slowed down the process and led to

high costs for advisors. Obsessive secrecy has contributed to problems in learning as actors both SPA employees and outsiders have been unable to learn from the experience of past cases.

SWOT Analysis of the SPA

Based primarily on the information above Exhibit IV-3 provides an assessment of the Strengths, Weaknesses, Opportunities, & Threats (SWOT) of the SPA during the research period - prior to restructuring at the end of 1992. This analysis shows the SPA as it is seen by the investors and consultants who worked with the SPA in the negotiation of privatization deals.

A categorization of many of the characteristics of the SPA was difficult. Depending on the point of view the same characteristic could be seen as either a strength, a weakness, an opportunity, or a threat. For example, the fact that the agency must report to a representative government gives it legitimacy which is a strength, but this also led to political influence on decision-making which was a weakness. Political influence also posed a threat to the very existence of the agency since it had to report to a government which had different objectives and it had limited power in Parliament. Likewise, the small size of the SPA was seen as a strength as it allowed for flexibility, but it was also a weakness since there was insufficient staff to manage all of the necessary work.

Exhibit IV-3
SWOT Analysis of the SPA

Strengths

- small size and dedication of people at the top has made it flexible and able to adapt and learn as the environment changes
- there are clearly some very good people at the top with open minds and good ideas
- the tender process is good in that it affords transparency and has allowed the SPA to maintain a reputation of fair dealing and honesty.
- legitimacy: the SPA is generally seen as honest and above board
- availability of information has improved dramatically particularly with the new newsletter listing what is available for privatization.
- the self-privatization program appears to be running relatively smoothly and was brought in effectively and with relative efficiency.

Weaknesses

- a lack of effective hiring practices and personnel relations
  - a lack of effective training programs
  - high employee turnover rate
  - workloads too heavy and cases not allocated effectively
  - SPA is seen as a training ground for private consulting sector
  - hiring through who you know
  - salary structure dependent on high bonus potential where bonus is determined arbitrarily by your superior
- lack of internal communications at all levels and centralized information systems
  - a lack of coordination amongst the activities of the various parts of the SPA which leads to inconsistency
  - a lack of general knowledge of the processes and policies
  - an obsession with confidentiality and secrecy
- goals and mandate is unclear
  - a lack of focus on what is the purpose of the SPA and privatization as well as what the criteria for assessing proposals
  - mandate has been interpreted as being to bring in as much money as possible as soon as possible.
  - goals change as parliaments perception perceived priorities changed, (ie. the importance of speed in the process)
- political nature of the SPA
  - the configuration of the SPA and its management is politically oriented and bureaucratic in nature.
  - perception that people at the SPA are acting in their interest to keep the SPA alive not in the interest of the country
  - strong political influence on decisions combined with a weak political position.
  - a lack of adequate guidance from parliament and a lack of political power to carry out the legislative powers it has.
  - policy guidelines have not kept up with either the changing environment or the changes in legislation.
  - as a bureaucratic government agency it does not act on true 'ownership interests in its decision making.

**Exhibit IV-3
SWOT Analysis of the SPA**

- attitudes and behaviour of people not conducive to open and effective negotiations
  - lack of knowledge and experience, not learning as quickly as private sector because of high turnover and not a great a motivation. In private sector must learn to survive.
  - power games being played by inexperienced people given too much power and authority without responsibility
  - lack of trust both within the SPA and outside
  - obsession with secrecy and confidentiality
- physical lay-out of offices not conducive to communications and a lack of central meeting areas to encourage discussion.
- high cost and unavailability of information on what is available for privatization as well as procedures for the process.

Opportunities

- Hungary is likely to be the first of the East European countries to get out of the recession and provided it is able to stay ahead of the rest in terms of reforms toward a market it will continue to be the major foreign investment ground.
- The SPA is small enough and has not got funding to effectively restructure provided it can stay alive long enough.
- Outside advisors and consultants could be used more effectively and cooperation with them might improve the process. An idea was raised by one consultant of a person swap where private consultants would work in the SPA for some time providing their expertise and SPA employee could work in the consulting firm to see the other side of the business.

Threats

- the process is too slow and as time passes the firms are losing value and becoming unsaleable.
- the attractiveness of other East European countries is improving and may divert investment away from Hungary.
- a recession in the West has drawn foreign capital away from Eastern Europe.
- the new Bankruptcy law will mean that many state assets will go out of SPA control after all as firms declare bankruptcy and assets are liquidated to pay creditors.
- strong political pressure to bring in hard currency which is caused by the economic pressure being put on the government and by the limited political power it has.
- political pressure threatens the very existence of the SPA as a privatizing entity. As more functions are being disseminated to separate LLCs formed by the SPA to do functions beyond the abilities of the SPA, the role and importance of the SPA is diminished. ie. The Pri-Man to govern self-privatization, and the State Owner company to hold assets which are to remain in state hands permanently.

As the table points out the greatest strengths of the agency came from its legitimacy and transparency as well as the fact that there were a few good people at the

top who were eager to find answers to the challenge of privatization. The agency's weaknesses stemmed primarily from political and human resource problems. A lack of effective human resource management together with understaffing and a lack of communication were key problems in the agency. These were combined with a hostile attitude of employees towards outsiders and the political influence.

The opportunities of the agency came from the fact that Hungary has been in the forefront in economic reform and privatization and has been the lead country in Eastern Europe for attracting foreign investors. Furthermore, private industry and international agencies have been eager to work with the agency and the agency was small enough to be able to adapt to changes. Threats to the agency came from the political influence. Infighting in parliament threatened the existence and autonomy of the SPA; and changes in the international and domestic economy dictated a need for quick privatization.

CONCERNS OF INVESTORS REGARDING PRIVATIZATION

Many of the concerns of investors regarding privatization stemmed from the weaknesses of the SPA mentioned above. These weaknesses led to delays in the processing of deals and many frustrations. In this section, concerns raised by investors and consultants regarding the privatization process are considered including⁵⁸:

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⁵⁸ Further discussion of some of these concerns as they applied to the case studies considered in this research is found in Chapter VII.

- Uncertainty regarding ownership rights;
- A lack of information and uncertainty regarding procedures & decision criteria;
- Perceived unfair dealings in the tender processes; and
- Problems with valuations

Uncertainty Regarding Ownership Rights

While the 1990 legislation governing privatization specified in law that the state was to be the owner and set out the rights of such ownership, in practice there were still many ambiguities which lead to confusion in negotiations for the sale of companies. Ambiguous ownership rights meant that the purchase of a privatized SOE in Hungary was not a simple negotiation between a buyer and seller but in fact involved complex negotiations between three or more parties each with different goals and objectives.

Differences in objectives led to complex negotiations and the possibility that good deals would not go through because of the inability to reconcile these differences. The majority of problems in this area stemmed from differences in the goals of the SPA and the management of the SOE being privatized. In general investors found the company management helpful in investment negotiations. In some cases, however, the management was reluctant to give up the power it had acquired under the old system and tried to block privatization as they feared losing their jobs. In such cases, the SPA had the right to the privatization of the enterprise by taking over control of it and replacing the management. This fear of the SPA was very strong. As one Hungarian lawyer stated in an interview: "The perception is that the general manager's position goes out to tender along with the company". This comment was mentioned by several interviewees as a major barrier to negotiations.

The fear of an SPA takeover led to many attempts by management to sabotage the deal or to destroy the future viability of the company. Direct evidence of such resistance by management to privatization is difficult to find since people are generally not willing to talk about such things and much of this took place in the earlier stages of privatization, prior to government controls. However, through conversations with various consultants and lawyers working in privatization it is clear that this phenomenon has occurred and has continued to be a problem. Some rumours of this were seen at the initial stages of the privatization of Malev, the Hungarian airline company. In the end the general manager was let go to enable the privatization to take place.

According to the SPA, it was generally rebellion by management which led to the SPA taking the company under its control and firing the management. However, the SPA was also known to take over control of an SOE in cases where the management did not want to block privatization but rather had welcomed it. In many cases, the SPA took control over the company after management and the potential investor had already completed negotiations of a deal. The investor then had to start over again with negotiations involving the SPA and the new management of the company. This could mean that months of negotiations were lost and in many cases the original investor did not end up getting a deal at all. That investor could be cut out by a competitor. The unpredictable nature of the SPA in such cases meant that the investor had no idea if a deal was done until it was signed, sealed and delivered⁹⁹.

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⁹⁹ Specific examples of this are found in Chapter VII.

Lack of Information Uncertainty Regarding Procedures and Decision Criteria

One of the most common questions asked by investors was; "What are the acceptable provisions in negotiations with the SPA?" As one consultant responded "We never can tell. Something may be accepted in one case and rejected in the next for no apparent reason". The privatization process evolved in an ad hoc manner and it has been difficult to keep up with changes in the privatization procedures and in the more subtle areas of decision criteria or restrictions on investments. As one interviewee commented: "the organization and procedures change so often that even those within the SPA don't know what is going on or who is really responsible for what." This same interviewee pointed out that he no longer takes the time to determine who he should see at the SPA or what channels he must go through. He simply goes to the person in the SPA whom he knows and takes it from there.

Constant changes in personnel in the SPA and the lack of communication and training combined with the lack of directives from Parliament created a situation of uncertainty and a lack of continuity. It has been impossible for the SPA to give concrete information regarding decision criteria and procedures because they have not been given clear guidelines from Parliament which, combined with the SPA's lack of political power, has left them vulnerable to the whims of parliament.

The perception regarding decision criteria was that there has been a lot of emphasis on price. The best way for the SPA to justify its existence and its privatization policies was through bringing in capital, particularly foreign capital. However, even having the best price might not have been sufficient. Political pressures in the SPA

implied that sensitive issues included; price, employee/management participation and future investment, however their relative importance remained unknown and appeared to change dramatically based partially on changes in government priorities. When the government changed its priorities to encourage domestic ownership, due to public backlash against FDI, the SPA had to develop new priorities and programs designed to encourage domestic investment. According to one former SPA employee: "there is a need for compromise between the short term goal of getting money and the long term future viability of the company being privatized." The outside perception has been that the importance of these criteria have changed from case to case and leaving no consistency in decisions.

Information regarding the SOEs up for privatization was also limited as the SPA appeared to be more oriented towards gaining control over assets than on selling them (Tozsde Kurir, 14/11/91). What information that was available was often unclear and unreliable. While the situation was believed to be improving with more standardization in procedures, it has remained a strong hinderance to privatization. Furthermore, as one interviewee commented, the information has tended to be costly and could be too expensive for the smaller investors or investment consultants.

The Privatization and Tender Process

The concerns regarding tender issues in Hungary was the subject of an article in Business International's publication Business Eastern Europe (BEE) which stated that:

As one puzzled US publisher told BEE, "The Hungarians are floating tenders at such short notice that you can't help wondering if these tenders are for form only". Other reported difficulties so far include:

- ambiguously worded, inaccurate and incomplete tender specifications with vague terms and rules; these often aggravated by incorrect translations from the original Hungarian text;
- erratic tender deadlines;
- demanding Hungarian language bids at short notice;
- negotiating over related contracts with bidders between the tender opening and closing dates; and
- disregarding bidders' process or comparing 'incomparable' technical parameters.

This issue was crucial to investors since most deals in Hungary went to tender and problems in the process have caused investors concern. Many interviewees commented that, often open tenders were called when they were not really necessary. This caused delays in the process and frustration to investors who had done a lot of research and sunk considerable finances into the potential purchase of a firm only to lose out during the tender process.

The tender process was crucial for the SPA to maintain an appearance of legitimacy and transparency in the privatization process, but problems in the process led to questions of corruption in the use of the procedure. The criteria used to evaluate a given bid was unclear and there was no consistency in decisions or feedback on rejected tenders. As another interviewee pointed out: "You submit a bid, the SPA then says they will consider it. From there the outcome can be acceptance, rejection, or a request to revise the bid. However, the SPA never will say what in the bid was alright and what needed to be revised."

Cases have also arisen where, a firm's competitors have undermined a bid simply to keep that competitor out. They are not necessarily valid strategic investors and as

such not necessarily the best owners for the firm. This was particularly the case where a joint venture partner who had worked with the SOE and understood its needs was outbid by a competitor. One case was described where the SPA had originally guaranteed that a certain company would not be invited to bid. This was said to have been agreed to by that company, but when the SPA issued the tender it not only invited that company to bid but strongly encouraged it. This prompted the firm to reconsider its agreement to not bid and out-bid the first firm.

There was also a perception that there was insufficient flexibility within the SPA in the acceptance of alternative ideas for privatization or benefits beyond price. In western acquisitions alternative financing options tend to be the rule rather than the exceptions, however, investors have found the SPA unreceptive to such options. As one investor pointed out: "this concept of flexibility is not only more important in the East where uncertainties with regard to valuation and future economic conditions are greater, but it will also become more crucial in the next stages of privatization as the firms available become less attractive to investors."

Valuations

Most investors and players in the privatization process agree that the valuation of a state owned enterprise in the former socialist economies has been more of an art than a science. Over time a relatively standard methodology for at least some form of consistency in values has been developed in Hungary. However disputes over value have continued to be the main stumbling block in negotiations. Valuations are difficult in the

best circumstances and in a situation where there are neither effective capital markets nor a true market for assets, they have been almost impossible.

There are two different methods available for the valuation of a company; The Asset Valuation and the Business Valuation. The *Asset Valuation* determines the fair market value of the firm's tangible assets assuming that those assets will be for continued use as part of an ongoing profitable enterprise. In these circumstances, the fair market value is defined as

The cash, or cash equivalent, price at which the property would change hands between a willing seller and a willing buyer, each knowledgeable concerning all relevant facts, and neither being compelled to buy or to sell and with equity to both (International Valuation Services asset valuation report).

In a normal market economy the determination of this value is relatively straight forward due to the abundance of market information on prices. However, market information is not readily available in Hungary. The obsession with secrecy and confidentiality inherited from the old system has meant that information on actual sale prices, particularly for land and buildings, is not publicly available. Even when information is available, it does not generally reveal the actual price. Under the table deals are often made to avoid paying taxes or other legislative issues. For example, since privatization regulations state that the land belongs to the city councils, in the official records for the sale of a site the building value is generally raised and the land value is lowered.

Valuers therefore had to use other methods to determine the market value of the tangible assets. The two other options are the Cost Approach and the Income Approach. The *Cost Approach* takes the current cost to reproduce or replace the asset and takes off

a deduction for physical depreciation, functional obsolescence and economic obsolescence. The *Income Approach* develops a value through capitalization or discounting techniques applied to an estimate of the income which would be derived from the future ownership of the subject property. Of these two methods, the Income Approach is generally preferable. However this approach requires a detailed business plan which, given the uncertainty of the market, has been difficult to obtain since any forecasts of future income remains uncertain. This has left the cost method which is the least attractive.

The *Business Valuation* generally applies the income approach to provide a fair market value of the business as an ongoing entity based on capitalization or discounting of its projected cash flow in income. As in the case of the income valuation of the tangible assets, this method depends on the business plan and the forecast of income for at least five years.

The difficulties in performing valuations has been a major obstacle in the negotiation of most privatization cases. The SPA has tended to hold out for a higher price and it has been difficult to explain the concepts of valuations to the SPA case officer. Under the Communist ideology it was assumed that assets of production had a value independent of what anyone is willing to pay. This implied that the book value of assets was considered to be the true value. However, book values cannot be relied on as they are based on the old system of book keeping and do not reflect true value. Furthermore, the earning potential of assets is overlooked by using the book value (Toltzman, 1992/93)

These problems of valuation and negotiating value with the SPA has been compounded by the fact that the experts have been able to tailor a valuation to the demands of the customer. Case officers of the SPA, not being knowledgeable regarding the intricacies of valuation accept the value they want to hear⁶⁰. Since the SPA's priority has been to attain a high price, if the SPA commissions a firm to do a valuation there is an incentive for the firm to submit a high rather than low valuation. If that same firm were working for the investor he would submit the lowest possible valuation. This forms the basis of many delays and problems in the negotiation of deals.

CONCLUSION: Concerns Regarding Privatization

Problems associated with the privatization process and negotiations with the SPA have taken two forms. The first is the problem of determining who has the rights to negotiation the sale of the enterprise and along with that the difficulties of resolving conflicting goals between the state and the SOE's management. The second is delays in the negotiation of deals which are a result of various factors not the least of which are weaknesses in the structure and organization of the SPA. Exhibit IV-4 provides an assessment of the positive and negative factors in Hungary's privatization programs.

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⁶⁰ According to one interviewee: " Valuations and price setting, when done within the SPA, are done in a department separate from the regular case officers. Then the price derived must be justified to the case officer." The case officer generally has no knowledge of how the price was derived and as such negotiations with him on the basis of price can be fruitless.

**Exhibit IV-4
PRIVATIZATION ISSUES**

	Positive Factors	Negative Factors
<i>Ownership</i>	• The legislation governing the SPA clearly outlines state as owner.	• In practical terms the legislation failed to address conflicting interests of all parties thus problems still exist.
<i>Delays & problems with the SPA</i>	• On the surface it is a legitimate agency functioning with complete transparency and with talented and dedicated people at the top.	• In practice there are many frustrations with dealing with the SPA. • Delays caused by a bureaucratic system, understaffing, problems with valuations, and political influence. • Perceived unfair practices in tender process. • Hostile attitudes of employees towards outside consultants and investors. • Uncertainty regarding decision criteria and procedures. • Lack of available information.

CHAPTER V.

FOREIGN DIRECT INVESTMENT & PRIVATIZATION EXPERIENCE

The purpose of this chapter is to set the stage for the selection of the case studies and to demonstrate that, despite all of the problems associated with privatization in Hungary (Chapter IV) and an unstable investment environment (Chapter III), foreign investors have remained interested in Hungarian privatization.

Foreign Direct Investment In Hungary

As mentioned in the legislative environment section of chapter III, Hungary first allowed foreign direct equity investment in the form of the joint venture in 1972. This made it one of the first countries in the region to allow this form of partnership with foreign companies. Over the next 20 years restrictions on such investments eased and Hungary has been able to attract a substantial portion of the total FDI capital destined for the Eastern Europe and the former USSR.

At year end 1991 over 50% of all FDI in Eastern Europe went to Hungary and while that percentage may be decreasing, as the other countries catch up with Hungary in terms of reforms, the volume of investment continues to increase. Exhibit V-1 shows the total FDI in the five most open East European countries and their percentage of the total for December 31st 1991. Exhibit V-2 shows the increase in cumulative FDI in Hungary over the period 1988 to June 1992. By the end of this period over USD 2,800 million had been invested in Hungary representing approximately 8.9% of the country's GDP (OECD draft report 1992). In the first six months of 1992 over USD 800 million

was invested in Hungary.

Exhibit V-1 FDI inflows into East European Countries		
Country	FDI (million USD)	Percentage of Total
Poland	680	15 %
Czechoslovakia	1,100	24 %
Hungary	2,300	50 %
Rumania	230*	5 %
Bulgaria	300*	6 %

*figure for October 1991

Source: OECD draft document December 1992

Exhibit V-2

Foreign Direct Investment
(cumulative total in million \$US)

Source: Hungarian National Bank monthly report August 1992.

In terms of the number of FDI projects, as of October 1992, over 13,500 projects involving foreign capital were registered in Hungary. This represented an increase of

2,500 over the year end figure for 1991. As of December 1991 over 11,000 projects were registered of which 5,642 were in the manufacturing sector. These projects involved a total initial capital of over USD 1,734 million⁶¹ (HUF 138,751.6 million). Exhibit V-3 shows the breakdown of the number of investment projects by industrial sector for 1990 and 1991.

Exhibit V-3 Breakdown of FDI projects by industrial sector				
	1990		1992	
Industrial Sector	# firms	Capital (HUF)	# firms	Capital (HUF)
Mining	1	700	-	-
Electricity	3	5	2	2
Iron & Steel, nonferrous metals	13	3,371	14	3,343
Manufacture	820	33,803	1,024	84,434
Construction	341	5,263	441	13,710
Agriculture	45	979	82	499
Transport	95	559	109	1,479
Domestic Trade	1,281	13,339	2,019	15,823
Foreign Trade	512	4,211	1,152	3,290
Other Material good & Services	117	1,305	93	1,748
Non-material activities(business, health, personnel, cultural, community, etc)	586	7,274	706	14,424
TOTAL	3,814	70,809	5,642	138,752

source: OECD draft document December 1992.

⁶¹ Assuming an exchange rate of 80 HUF/USD

From the figures in Exhibit V-3 it is possible to get a feeling for the amount of FDI in Hungary destined towards manufacturing and other nonagricultural or service sectors. The total 1991 year end initial capital for industrial sectors (including: mining, electricity, iron & steel, manufacturing, construction, transport, and other material goods) is HUF 104,716 million or approximately USD 1,309 million. This is approximately 75% of the total value of new projects and over 62% of total FDI in Hungary for that time. This number is confirmed by Hungarian governmental estimates which state that as of June 1991 over 60% of all FDI had been destined to manufacturing sectors (Tozsde Kurir, 04/07/91). The number of projects in the industrial sector is 1,683 projects or 30% of the total. From this we can conclude that while the majority of FDI investment projects in Hungary are not in manufacturing sectors, the majority of the value of FDI is.

Privatization Experience in Hungary

Pseudo privatization in Hungary first started in 1988 under the label "*Spontaneous Privatization*"⁶². Through a loop hole in the 1988 *Company Act* managers and enterprise councils of state owned enterprises were able to essentially transform either all or part of their enterprises into private companies through first forming a private company, then transferring the assets of the SOE into the new company at either no cost or unreasonably low prices. It is not known exactly how many companies were privatized in this manner during the time leading up to the formation of the SPA, but if

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⁶² This is not to be confused with the controlled spontaneous privatization which took place after the formation of the SPA.

the level of public outcry against *Spontaneous Privatization* is any indication, there were quite a few⁶³.

Official privatization under the control of the SPA got off to a slow start with only 27 cases being processed in the first nine months of operations. That is not to say that 27 companies had been privatized but rather 27 transformations had been approved. It is difficult to estimate the exact number of companies which have been privatized as it is unclear exactly what degree of private ownership implies that a company is officially privatized. Many companies have been transformed into private companies under the *Transformation Act* but the sole owner remains the state. Statistics in Hungary have used the transformation of a company as the signal that it is privatized but if the state remains the majority shareholder is it really privatized? Unfortunately the only statistics available for the extent of privatization are numbers of transformations and this must be used as an indicator. Privatization income from foreign investment during this period was estimated to be approximately USD 6.75 million (HUF .54 Billion).

During 1991, while the pace improved, privatization was still far below estimates. The budgeted income for 1991 was HUF 50 billion, whereas the actual income was only HUF 30 billion. Approved transformations totalled only 216 which meant approximately 20% of the previous state sector had been transformed into corporate form at this point. It was estimated that by the end of 1991, only 10% of the former state sector was operating directly under private control. Foreign capital invested into privatization was estimated at USD 770 million which accounted for approximately 60% of the total FDI

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⁶³ Discussion of these outcries was seen chapter IV under the issues of ownership rights.

in Hungary. In fact foreign capital was estimated to be over 85% of all income generated by the SPA during 1991 (Hollo, 1992).

By late 1991 and early 1992 the pace quickened and by mid 1992 statistics showed that, with the exception of the former East Germany, Hungary had had the most success in privatization of all East European countries (SPA press release). By June 1992 it was estimated that over 370 transformations had been approved (Exhibit V-4), 40% during 1992. The percentage of FDI income destined for privatization at this stage was estimated to be 70%.

Exhibit V-4

Number of SOEs Transformed into Economic Assoc.
(cumulative total # SOEs)

Source: Hungarian National Bank monthly report, August 1992.

Statistics have demonstrated that the primary source of investors in the privatization of Hungary's economy, particularly for larger SOEs, has been and will

continue to be foreign investors. This is due in part to a lack of sufficient domestic capital as well as the perceived extra benefits to be acquired from foreign investment in the form of access to markets, know-how, and technology. Exhibit V-5 provides a list of the 10 largest cases in 1991.

Exhibit V-5 Ten Largest Privatizations in 1991	
*Sanofi -Chinoia	
United Biscuits -Gyori Biscuit and Wafer Co.	
*Sara Lee -Compack	
Public Plc.- Styl RT	
*Electrolux -Lehel	
Messer Greisheim -ODV	
Nestle - Szerencs Chocolate	
Julius Meinl - Csenge	
Interbru - Borsot Brewery	
Zwak-Undabert - Buliv	
Siemens -Electrical Rt	
*Philip Morris - Eger Tobacco Factory	

* Cases considered

Conclusion

From the above facts it is possible to conclude, not only that foreign direct investment continues to flow into Hungary but that a good portion of this money is going into the privatization of the manufacturing sector. Additionally, the statistics demonstrate that investment in the manufacturing sector has tended to be large scale.

CHAPTER VI. CASE STUDIES

The cases selected for analysis in this paper represent a sample of the largest MNE acquisitions in Hungary's manufacturing sector. Cases have been selected based partially on their potential role in explaining elements in the acquisition decision and partially on the availability of information and the willingness of the Western MNE to be interviewed. The cases depict a cross section of industries and countries of origin as well as different methods of privatization and percentages of ownership acquired. Each case involves a large strategic investment by a globally oriented MNE which resulted in the transfer of control of the operations of the target enterprise to the acquiring MNE.

Most authors, in their analysis of privatization programs, have divided privatization into two major categories; small and large. Small defines those privatizations which can take place immediately and are primarily destined for domestic investment. These privatizations include the majority of the retail and services sector in Hungary and generally do not involve investment by western MNEs. For this reason, as well as the fact that information is more readily available for the larger cases, smaller cases were not considered in the analysis.

Within the category of larger privatizations there can be found examples ranging across sectors and industries. At the time the research was initiated there had not been sufficient experience in one industry, to justify an industry-specific study. Therefore, the cases were selected on a sectorial basis. The manufacturing sector was considered to be the most appropriate for several reasons:

- Manufacturing represents a significant part of Hungary's economy and it consists primarily of large state-owned or cooperative producers which often hold monopolistic positions in the market⁶⁴
- Due to the scope of their operations and the lack of domestic capital or suitable institutional investors in Hungary, the privatization of such enterprises must generally involve foreign ownership. The majority of these large manufacturers are not competitive on the world market and their problems can only be solved through foreign investment providing an influx of financial capital, know-how, modern technology, and access to new markets⁶⁵.
- Retail and agricultural sectors in Hungary were relatively advanced in Hungary due to reforms under the NEM which gave private actors in these sectors more autonomy. The manufacturing sector has remained the most closely controlled by the government with the result that foreign investment has a greater role to play in the manufacturing sector.
- In the manufacturing sector information has been more readily available than in smaller retail and service sectors, and the agricultural industry holds special issues of land ownership which would greatly complicate the analysis⁶⁶.

In selecting only cases where MNEs have invested through acquisition of former SOEs the growing field of greenfield investments⁶⁷ and joint ventures are ignored within the realm of Foreign Direct Investment (FDI). This limitation is made both to simplify the research and limit the variables to be considered. It should also be noted that many of the issues raised in this analysis would also apply to greenfield investments and joint ventures. In privatization cases, MNEs not only have to deal with the question of

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⁶⁴ It has been estimated that this sector accounts for 36.2% of Hungarian GDP (Prospectus, 1991: 30) and that large companies account for up to 75% of the economy's industrial output.

⁶⁵ In fact, to date approximately 60% of the foreign investment in Hungary has been in the manufacturing sector (*Tozade Kurir*, 04/07/91).

⁶⁶ Due to nationalistic tendencies, Hungary has been relatively reluctant to allow vast amounts of FDI in its agricultural sector.

⁶⁷ The term greenfield investment refers to new investments.

ownership and the government in the purchase of the SOE but they also inherit many environmental, labour, and efficiency problems which would also be found in other forms of direct investment. While it is beyond the scope of this research to consider the applicability of the findings uncovered to these other forms of FDI it is certainly an interesting area for future research.

GENERAL ELECTRIC (US) - TUNGSRAM

Importance of the case

American companies want to see if giant G.E. can pull it off before they decide whether to take the plunge into Eastern Europe. Hungarians want to see whether America's vaunted capitalist magic can make TUNGSRAM gleam again." (IHT 17/12/90: 12)

The General Electric (GE) - TUNGSRAM joint venture was one of the first major foreign investments which involved majority ownership and control by a major western MNE. Also it represented the privatization of one of Hungary's best known, and most profitable companies. As such it received much publicity and many of the problems faced in the negotiation of this venture, as well as in the day to day function of the venture, have helped shape the current investment environment in Hungary.

The primary importance of the GE case to this research lies in the fact that it is currently well established and, according to GE, a successful venture⁶⁸. The lessons

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⁶⁸ Interview T. Stanton, VP Marketing Tungsram.

learned by G.E. in the past two years are invaluable to understanding the potential problems which will face foreign investors purchasing a controlling interest in Hungarian SOEs. Many of the problems which G.E. has faced will be faced by all potential investors and the experiences of how GE has addressed these problems can provide considerable insight into what makes an investment in Hungarian privatization a success.

Tungsram

Tungsram has been in the lighting business since 1886, only eight years after Edison announced his patent (HTJ, 05/89: 11). It is one of the world's ten largest manufacturers of light sources, with 12 production plants and worldwide sales organizations. The majority of the company's production is sold to foreign markets. Estimates have shown that in 1989 approximately 80% of sales were exports to hard currency markets (NYT, 16/11/89: D7). As of 1989 the firm held 7-8% of the West European market. According to an interview with Tungsram's new VP marketing, Tom Stanton: "Tungsram had a very strong brand image and is number one or two in many major markets".

While Tungsram showed evidence of many of the weaknesses inherent in most SOEs from the former socialist countries, it had been a flagship in Hungarian industry due to its strong international name. The company received many benefits such as special privileges and extra funds for expansion with the result that it remained able to compete internationally. It had a strong research and development capability, produced

a wide range of related products and had integrated vertically into processing raw materials for supply to production. Unfortunately, due to the firm's international character many of the benefits were offset in the later years of the 1980s by excessive taxing of its hard currency earnings, particularly when the Hungarian government faced severe external debt management problems.

Transformation

While officially TUNGSRAM maintained joint stock company status during the nationalization of the Hungarian economy, in practice it functioned in the same manner as all other SOEs. While transformation did not actually involve the formation of a new legal entity, a form of transformation did have to take place in order for the company to be privatized. It was in 1985 that TUNGSRAM first started efforts to restore its joint stock status (HMR, 07/89:32). This effort was prompted by financial difficulties in the early 1980s and TUNGSRAM turned to the World Bank-financed Programme on Industrial Restructuring for advice on the necessary restructuring of the company. According to Istvan Maly, the then Director of TUNGSRAM and general manager of data processing:

In the 80s it became clear that the maintenance and improvement of the company's situation were only possible if various issues of company management were reconsidered and a suitable strategy was elaborated (ibid: 30).

This request to the World Bank for aid led to a study, by foreign consultants, of the company's strategic options. The study included an analysis of; product/market strategy, organization, technology, management systems, and information systems.

Armed with the recommendations of the study TUNGSRAM management developed a new strategy to focus on light sources and increase market share world wide. Priority was given to restructuring the company which included reorganization of management, modernization of its accountancy and cost accounting systems, rationalization of production relations between facilities, and major cuts in staff numbers and overhead costs. It is estimated that these cost-reduction efforts saved TUNGSRAM HUF 350 million (approximately USD 4.7 million) in 1988 (ibid:32).

Despite the company's restructuring efforts, its financial position continued to deteriorate causing the Hungarian state to seek a private partner. In December 1988 the company was officially 'privatized'. The state controlled Hungarian credit bank exchanged its USD 83 million in TUNGSRAM debt for a 92% share in the equity of TUNGSRAM (BW, 30/07/90: 33) and thus became the majority shareholder of the newly privatized company. The remaining 8% share remained in the hands of the state. It was debateable whether this could realistically be called privatization since in reality ownership was simply transferred from one state owner, the Ministry of Industry, to another state controlled entity.

In May 1989, the Hungarian bank sold 49% equity in the company to an international consortium which consisted of 13 financial institutions, headed by the Austrian Bank Girozentrale, for 110 million US dollars. This opened the door for foreign investment and the true privatization of the company. This move has also been said to have "legitimized the concept of selling shares of Hungarian industry" (BEE, 04/12/89: 386). One of the primary conditions of this sale was that within three years

the shares were to be floated on Western markets.

General Electric came into the picture, officially, in October 1989 just one month prior to a November 14th announcement by GE of its intention to purchase 50% plus one share of TUNGSRAM thus taking over majority control and management of the company. The speed of negotiations were mentioned by many sources. One source, Business Week (BW), outlined the negotiations in a July 1990 article as:

At a Vienna restaurant one night last August, GE Lightings's Woodburn drew up a plan on the back of a napkin and handed it to TUNGSRAM's bankers. By December, he had a deal (BW, 30/07/90: 33).

It is important to note, however, that GE first showed interest in TUNGSRAM back in 1987 and as such had been monitoring the progress of changes in the company. One explanation given for the speed of the deal is that GE was not the only company interested in the purchase of TUNGSRAM. Other interested parties included Phillips [Netherlands], Osram [West Germany & UK], and Thron EMI [UK] (BEE, 04/12/89: 386).

According to the deal GE purchased controlling interest in TUNGSRAM for USD 150 million with the option to purchase an additional 20% in the future. The USD 40 million profit is reported to have been split equally between the Hungarian Bank and the international consortium (ibid). However other sources state that TUNGSRAM received USD 22 million of the profit (BW 30/07/90: 32 & HTJ 02/90). The allocation of the profits from the deal became something of a public scandal in Hungary particularly as the international consortium was reported to have received a large chunk of profit for essentially no work. In fact it was scandals such as this one which lead Hungarians to

consider more close control over privatization and the allocation of profits.

The logistics of the deal were interesting as they demonstrate some of the confusion associated with earlier deals in Hungary. In order for GE to purchase the shares the 49% ownership had to be returned to the Hungarian Credit bank by the consortium which in turn sold the 50% plus one share to GE. GE took over control and management of the company as soon as the deal was signed and has initiated many reforms within the company.

General Electric's Strategic Goal

GE's strategy, or goal, in purchasing TUNGSRAM was well publicized and quite clear; GE was purchasing market share in Western Europe. According to George Varga, the President of the new venture formed with GE and TUNGSRAM: "West European market share: that was reason 1, 2, & 3," everything else he describes as a 'kicker' (FT 26/09/90: 12). However, to fully understand this strategy and its true significance, it is important to understand GE's global strategy and to recognize how the purchase fits within this strategy.

GE is competing in what has become a global industry for electronics and lighting products and the companies goal is to number one in that industry. According to the company's president and chairman, John T. Welch, "We have a strategy of trying to be number one in 13 global businesses" (NYT, 16/11/89: D7). Currently the company is in second place with Philips, the Dutch electronics company at the top. GE holds a large and stable position in the North American industry, however to be number one it must

obtain a substantial share in the West European market.

The purchase of TUNGSRAM was only one of several ventures GE entered into in its attempt to access the lucrative European market. With the coming of the 1992 European Common Market and the rationalization within industry as competitors form alliances and consolidate their positions in preparation for the union of European markets, GE found it necessary to establish a stable foothold in the market. In 1989 GE also formed a joint venture with Ericsson to market mobile radios and cellular phones and formed a link with PLC in Britain to sell appliances and electrical distribution equipment in Europe (ibid). Furthermore in November, 1990 GE acquired 100% of Thorn, a UK based firm which holds 35% of the UK electronics market.

GE's strategy for Europe, according to T. Stanton, VP marketing for the new GE TUNGSRAM venture, was to increase market share and presence of the GE name and specifically to increase the product line beyond specialty products thus providing a full product line to the West European market. Stanton described TUNGSRAM as the best candidate, particularly within Eastern Europe, because of its international presence and high market share within the West as well as its relatively good technology and broad product line which complements GE's.

According to Business Eastern Europe "[TUNGSRAM] provides GE with a suitable platform to expand in West Europe" (BEE, 04/12/89:). TUNGSRAM held around 8% market share in Western Europe which combined with GE's 2% makes the combined venture the fifth in the West European electronics market. Furthermore, with its geographically central location, its commitment to economic reforms, its past

experience with foreign investment, and its relatively advanced infrastructure; Hungary is the best foreign investment ground of the former CMEA countries TUNGSRAM has exports to over 100 countries and 80% of plant sales go to Western Europe.

HUNSLET (UK) - GANZ MAVAG

Importance of the Case

Like the GE case, the acquisition (officially the formation of a joint venture) leading to the privatization of Ganz Mavag represents one of the first deals to take place in Hungary. The primary interest of the case to this research stems both from its role in influencing future deals and legislation and from its experiences in overcoming the obstacles associated with acquisition investments in Hungary. Over the past three years, the firm has succeeded in transforming itself into a competitive, profitable manufacturer which meets Western standards in every way from product quality to manufacturing processes and human resources practices, according to the joint venture's general manager, Stephen Kostyal.

Ganz Mavag

In early 1989 the parent company Ganz was transformed into a private enterprise under *spontaneous privatization* and split into seven separate legal entities each of which involved in a different spectrum of the firms activities. Out of this transformation, Ganz Mavag became a separate legal entity. Ganz Mavag was the part

of the 100 year old enterprise which was involved in train and railway manufacturing operations ranging from engine design and manufacturing to rail rolling stock.

The Deal

Subsequent to the transformation of Ganz and the formation of Ganz Mavag, foreign investors were sought to facilitate restructuring of the firm's operations and to improve profitability. It was at this stage that the British investor came into the picture. The deal is officially termed a joint venture, however it was in essence an acquisition-privatization case typical of those which took place during the early stages of transformation in Hungary, prior to the formation of the SPA, under the name *spontaneous privatization*.

The British partner entered Hungary through the establishment of a %100 foreign owned 'joint venture'⁶⁹ under the name Ganz-Hunslet. Thereafter the assets and labour of Ganz-Mavag responsible for the manufacturing of rail rolling stock were rolled into the new legal entity as contribution in kind allowing the former management to take 49% shareholder ownership. The effective management and control of the new firm remained in the hands of the British investor who then undertook the task of restructuring the former SOE into a competitive quality producer.

Three years latter, at the time of the interview, the British partner initiated the process of buying out the Hungarian share. Under a mutually agreeable arrangement the Hungarian shares were to be bought at book value. According to the firm's general

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⁶⁹ In Eastern Europe, at that time, the term Joint Venture was used to describe essentially any equity investment involving foreign interests (McMillan, 1974).

manager, Steven Kostyal, the Hungarians were frustrated because they were receiving no dividends for their investment and given that the firm had not made a profit to date they were eager to dispose of their shares. The British partner was of the opinion that it was of no value to have a shareholder who was not a sophisticated investor and had no real input into the functioning of the firm except to attempt to get more money in the form of dividends or rents paid for land which is leased by the JV. The intention of the British partner was to completely buy out the Hungarian partner including land rights.

Hunslet's Strategic Goal

When asked why the British firm made the initial investment, Kostyal responded that the firm was looking to expand manufacturing operations and found the Hungarian operations to be a relatively cheap option with adequate manufacturing facilities. Under spontaneous privatization some firms were sold at 'bargain' prices and while Hunslet was not looking for a "quick buck" the low price allowed the firm make a reasonable acquisition and to finance solutions to the inherited problems associated with the past 40 years of communism. According to Kostyal, approximately 90% of the company's losses over the past three years could be directly attributed to problems inherited from the old company. Further consideration also came from Ganz-Mavag's position as the monopoly producer in a relatively active Hungarian market.

SANOFI (French) -CHINOIN

Importance of the Case

The most interesting point of this case is the structure of the deal which allowed for a decrease in the risk associated with the purchase, since the amount to be paid depended on realization of predicted profits. The case demonstrates one way to overcome the risks associated with determining the value of a company with less than perfect information in a relatively unstable, non-market economy. Furthermore this case demonstrates the problems associated with the loss of the former Soviet Union market.

Sanofi

Established approximately 18 years ago by the Elf Aquitaine group, a giant French firm with annual turnover of USD 25 billion, Sanofi's primary interests are in the pharmaceutical industry. It also has interests in the cosmetics industry (including Nina Ricci and Yves Rocher), veterinary products, and biotechnology. The firm's primary shareholder is the French government and it employs approximately 34,000 people. Annual turnover for Sanofi is \$3 billion (Prospectus, 1991: 70). Sanofi has also acquired majority ownership in several medium sized French pharmaceutical firms and has plans to purchase an American pharmaceutical interest, US Sterling.

Chinoin

Founded in 1910, Chinoin was one of Hungary's largest pharmaceutical

companies as well as one of the most successful and permanently profitable firms. Affiliated firms included Biochin Bp and Cyclolab Bp and the company had more than 200 registered medicines and pesticides which are exported to more than 80 countries. In all it had several hundred patented products on the market in Hungary and world wide. Production equipment was up to date and the industrial standards of the plants were at the highest level. Total employment at the firm was 4,200 of which 700 were employed in Research and Development (HER, 1991/2). The labour force was highly skilled with over two thirds having a University degree. Profits for 1990 were recorded at Ft 800 million and exports of intellectual property for 1991 were predicted to be approximately Ft 14-15 million.

Pharmaceutical Industry

The Pharmaceutical industry has been one of Hungary's primary and most competitive industries. It accounted for 3.2% of Hungary's gross industrial product in 1989 and a substantial portion of hard currency exports (Figyeloe, 18/07/91). The Hungarian industry is second world wide only to Japan's pharmaceutical industry in number of patents (HMR 1991/02-03).

In this industry, as of 1990, seven producers accounted for 90% of production. Chinoin was the first of these to be privatized. One of the industry's main concerns has been the maintenance of its market position in Eastern Europe and the former Soviet Union as competing MNEs enter the markets (Figyeloe 18/07/91). Further problems in the industry have come from limited financial resources which have prevented factories

from finding sufficient means to convert patents into products. Companies rarely had the financial means for mass production and the accompanying sales promotion. As one source put it:

As far as distributing medicine is concerned, it is not simply a matter of forwarding it to a pharmacy, even though that in itself is a long and tiresome procedure that generally takes from four six years. A product has to be tested after it has been accepted by a hospital or clinic. If it is then approved, it becomes available through the national health system. This is a complex and expensive process that demands financial resources and a well organized marketing network; something that would be lacking even if Hungary were not hamstrung by the strict economic controls that exist at present (HER,1991/02-03: 23).

Transformation of Chinoin

The transformation of Chinoin began in 1989 at the company's initiative. The consultants, Bear Stearn's Investment Bank, were brought in to advise and, together with the company, devised a two year plan under which the firm was to be transformed into a joint stock company and 60% of the resulting equity was to be transferred into private hands. By mid 1990 the company had been transformed into a joint stock company with the state holding 100% of the equity. At this point the search was on for private investors. According to the consultants the company needed a strategic, professional partner to bring in capital, technical development, managerial skills and new market possibilities. They recommended a public tender to which ultimately 75 potential investors were invited. The company decided that it would not accept majority foreign ownership and that at least 10% equity was to go to employees, either present or retired, on preferential terms. The company valuation showed that the value of the firm

depended on the realization of projects planned for the next three years and therefore the price structure must reflect that in order for the firm to get a fair price.

The Deal

Of the 75 bids tendered the best offer was by Sanofi. Negotiations began involving Sanofi, the company council and representatives of the SPA. These negotiations ended February 1991 with an agreement to sell 40% of Chinoin equity to Sanofi who would also have an option to purchase an additional 11% in 1994. In order to carry out the transaction, the enterprise council of Chinoin "effected a 33% increase in the capital base, which raised the 3 billion capital of Chinoin to 4 billion. 40% of the company's bonds became the property of Sanofi by way of purchase or subscription" (SPA internal documents). The most interesting part of the deal was the structure of the payments which reflected the risks associated with valuations of Hungarian firms in an uncertain market and economic environment.

According to the deal Sanofi paid USD 75 million for the initial 40% at the commencement of the contract for sale. Depending on the firm's profitability over the years 1991 to 1993, Sanofi would pay further instalments in the form of "conditional fees & bonus fees" (ibid). Of the initial payment 3/8th or USD 28 million was to go to the SPA and the remaining USD 47 million to be invested in the company for technical development and improvement of the firms liquidity. The final price to be paid by Sanofi is uncertain and is dependent upon the firms profits over the next years. Three possibilities have been reported where the total value of the firm is estimated at anywhere

from USD 188 to USD 290 or USD 410 million. The book value is reported to be set at USD 100 million (HER, 1991/2: 6). According to one source:

The agreement values Chinoin at \$188 million at present... If average profits during 1991 to 1994 are \$36.5 million, then Chinoin will be valued at \$290 million in 1994 and Sanofi will pay \$148 million, including the \$75 million already paid, for its majority share [51%] ... An average annual profit of \$45 million would give a value of \$410 million and payment by Sanofi of \$209.4 million (Vilaggazdasag 06/02/91).

Of the remaining 60% share, 10% was to be made available to employees at preferential rates and the remaining 50% would remain in the hands of the SPA to be disposed of at its discretion. However, Sanofi was unable to gain guarantees that the state holding of 50% would not be sold to a competitor prior to the 1994 deadline when Sanofi would be able to purchase the necessary 11% to gain controlling interest (ibid).

Preferential employee shares were distributed to employees for a total of 10% share in the company. According to SPA documents this preference took two forms. Up to a level of five shares per person, each employee could subscribe for shares at face value, with the concession of instalment payments over three years. Each employee could also subscribe to shares at face value in the form of cash payment without limitations but not to exceeding the 10% limit allotted for employee shares. Further concessions were granted by Sanofi who took on the payment of half of the purchase price on behalf of the employees (SPA internal documents).

To ensure equity in the satisfaction of demand for shares, distribution took place on a gradual basis, with shares allocated one at a time. That is to say each employee requesting shares was granted one share at a time ensuring that each employee had one before a second was granted. In this way employee access was guaranteed regardless of

their position in the firm and the widest employee ownership possible was achieved. According to the deal Sanofi guaranteed to assist the company's further progress and to encourage the preservation of the company's identity and business traditions. Chinoin would be integrated into Sanofi's world wide network and would be primarily responsible for Central and Eastern Europe.

Sanofi's Strategic Goal

The purchase of Chinoin was part of Sanofi's overall global expansion strategy to establish one of the largest pharmaceutical companies world wide. The nature of the pharmaceutical industry, with it's high research and development costs, implies the need for large economies of scale through which such costs can be allocated across higher volume output. Therefore, size is one of the most critical success factors in competition within the industry. With this acquisition and the purchase of the American interest, US Sterling, the group has become one of the ten largest drug companies world wide. It is reported that while Sanofi generally looked for 100% ownership it was willing to settle for a modest 30% share in order to draw the Hungarian company into its network and gain access to the East European market which Chinoin had serviced primarily in the past (HMR, 1991/02-03: 24).

SARA LEE/DOUWE EGBERT (US/Dutch) - COMPACK

Importance of the Case

Again the interest of this case stems from the fact that it is one of the first and largest privatizations. The case was completed after the creation of the SPA and it provides "a good example of how the SPA can take over the privatization initiative from the enterprise itself and ruin a Western Company's carefully laid plan" (BI, 1991: 81).

It involved a bid tender situation where the SPA took the company under its control after a deal had been agreed to, fired the management and subsequently accepted the offer of a competitive bidder.

Sara Lee/ Douwe Egberts

Sara Lee/DE is the 20th largest enterprise world wide with representation in over 80 countries. 1990 sales for Europe accounted for over USD 11.6 billion with profits of approximately USD 470 million. It is the second largest coffee roaster world wide and the largest in Europe. Other product lines include nuts, teas, rice, and sauce mixes as well as apparel (Dim hosiery and Champion brand active wear) and, through its Douwe Egberts (Dutch) acquisition in 1978, household chemicals and cosmetics.

Compack

The Compack Trading and Packaging company was founded in 1969 through the reorganization of the Packing Company of Food and Chemicals which was registered in

1962. It was Hungary's third largest food company employing as many as 2000 people and with annual turnover exceeding USD 140 million and 1990 profits of USD 14.85 million. Exports accounted for 4% of total sales and commission work accounted for 45% of turnover (Prospectus, 1991: 34). The company was the number one supplier of coffee, tea, spices, and rice in Hungary. As of 1991 it held approximately 65% of the legal Hungarian market for coffee and a monopoly position with 90-100% market share in tea, salt, and spices (HMR, 1991/10: 15). Like most SOEs in this area the company's monopolistic market share was threatened in the latter 1980s as competition was allowed to enter the market, particularly the market for coffee.

The Deal

Compack declared its intention to restructure in partnership with the German company TSCHIBO on Sept 4th 1990. The main reason for the transformation was that, with the appearance of foreign competitors, the company was losing its share of the domestic market and thus decreasing profitability. To tackle this shrinkage Compack management felt it needed new trademarks and new products.

Before the deal could be announced, Nestle (Swiss) raised a complaint with the SPA claiming that Nestle should have been consulted prior to any plans for transformation. Nestle had had ties with Compack since 1988 through an agreement which allowed Compack to distribute Nescafe instant coffee, to the domestic market, under another brand name. "Compack had poured the Nestle-patent pulverized instant coffee in the characteristic branded "Montreal" bottles." (HMR 1991/19: 17).

Taking into consideration this complaint and other declarations of interest in the company, control of Compack was taken over by the SPA and the general manager was fired. The SPA claimed that, while the price offered by Tschibo was 'fair' there had been other offers and there were allegations that Compack's general manager was receiving personal benefits from the deal. The price was not based on an independent valuation carried out according to international standards and details regarding future investments were unclear.

Negotiations subsequently began between Nestle, the SPA, and the new management. After several months, during which the SPA sought further offers, a closed tender was initiated. Invitees to the tender included the original partner TSCHIBO (German), Nestle (Swiss), E.D. & F. MAN (English), and SARA LEE/DE (US/Dutch). One of the conditions of the tender was that a maximum of 40% of Compack could be obtained in the first step.

According to the SPA only the SL/DE and TSCHIBO agreed to obtain only a 40% share in the first step, allowing for majority ownership only after several years. Since "the structure of the offers handed in by the two companies was the same the selection of the partner was decided according to the more detailed requirements of the call for tender" (SPA internal documents).

The ultimate decision was made by the general assembly of COMPACK and accepted. According to the SPA Sara Lee/DE offer was selected because it

"promised considerable improvements in all the domains of activity of Compack ... [Tschibo] could realistically have effected improvements only in the domains of coffee roasting and packing" (ibid).

Financially, according to the SPA, the Tschibo price was closest to the Sara Lee/DE offer. The company's equity was evaluated at HUF 4.5 billion. Tschibo's first offer to raise the accepted value of HUF 3.5 billion capital of Compack by HUF 500 million was amended to a bid of Ft1.3 billion for a 40% share. The Sara Lee bid was reported almost double that of Tschibo at HUF 3 billion (HMR, 1991/10: 16).

In the end a deal was concluded May 13, 1991 which allowed Sara Lee to purchase 51% of Compack for USD 60 million cash. The remaining 49% was distributed among workers (5%), local government and the SPA (44%) (ibid). By the beginning of 1992 Sara Lee had acquired 97% ownership with the remaining 3% being held by workers and the local government (interview Sara Lee).

The government's decision to allow for an increase in the share purchased by Sara Lee to a majority holding was prompted by political demands for acceleration of the privatization process and increased revenues. However, the SPA did require Sara Lee/DE to safeguard the status quo within COMPACK regarding employee rolls and directors tenure for the following three years.

The SPA justifies its interference in the privatization process and its replacement of the company's management by pointing out that while the first deal with Tschibo was 'fair',

Due to the call for tender, much better conditions were reached than in the first offer both from a financial and manufacturing points of view, this second being very important for the company. Not only a new coffee roasting will be constructed at COMPACK, but also a tea packing department with enlarged capacity, and a household chemical factory. With the coming into operation of these departments the level of employment at COMPACK will be stabilized at the current level." (SPA internal documents).

Sara Lee/DE's Strategic goal

According to a quote in the Financial times February 22, 1991 Sara Lee's strategic objective in purchasing Compack was "expansion into Eastern Europe, particularly into Poland and Czechoslovakia". Hungary is so centrally located that Sara Lee/DE could use the facilities here for export. The intention was to use Compack as a base to expand further into Central and East Europe. Additionally, Hungary itself represents a substantial coffee market being seventh in Europe for volume of coffee consumption (tied with Germany) (HMR, 1991/10: 17). Access to this market has been limited due to relatively high tax and duty rates. This has not stopped imports from Austria which account for two thirds of all Austrian Coffee exports. It has, however, led to a strong 'black' market in coffee. Furthermore, in 1973 Hungary quit the International Coffee organization with the result that it could no longer buy coffee directly from the producers but had to go through suppliers.

Through its Douwe Egberts subsidiary, Sara Lee also intended to add baby-care and body-care products to the existing list of products sold and manufactured by Compack. According to Sara Lee Chairman and CEO John Bryan, in an interview with the Wall Street Journal Europe, the intention was:

to introduce shoe polishes, insecticides and food branches as well as Western style marketing techniques ... We'll be working to distribute and strengthen their brands but will also be introducing our brands including Douwe Egberts, Van Nelle and Nerrild & Chatroin coffees as well as Pickwich and Van Nelle teas (WSJE, 21/02/91: 5).

To do this Sara Lee plans to import marketing, finance and production executives to Compack's management team, which will continue to be led by a Hungarian. A

distribution capability will be built and advertising and market research will be performed along with the introduction of new marketing techniques. New equipment will be sent in from Holland to produce vacuum-packed ground coffee and some plants will be closed in a rationalization of production designed to increase efficiency. As such Sara Lee has recently purchased a coffee company in Czechoslovakia.

ELECTROLUX (Sweden) - LEHEL

Importance of the case

Lehel represents a decision of the government to sell 100% to foreign investors. It also demonstrates how environmental problems are inherited when the firm is purchased (SPA internal documents).

The importance of this case comes primarily from its status as the first case where the Hungarian government agreed to sell 100% ownership to foreign investors. It is also one of the first and largest privatizations completed through the SPA. Of particular interest for this analysis, beyond the traditional problems seen by all MNEs considered, are the complex issues regarding environmental problems which Electrolux inherited in the purchase. Environmental problems may be a strong deterrent to FDI in the former socialist countries as there is no clear legislation on the responsibility for environmental clean up. 40 years of communism has created numerous ecological disasters and the question of who should clean up the mess is still unclear in many situations.

Electrolux

Electrolux is a Swedish based company with operations in 46 different countries. As one of the worlds largest manufacturers of household appliances, the majority of the company's sales are outside Sweden. It is the market leader in Europe which accounts for 45% of the company's sales and the third largest white-goods manufacturer in the US. Under the brand name Frigidaire the company has 25% of its sales in the US, the worlds largest market (Annual Report 1991). In Hungary Electrolux has had strong ties to Lehel and it is reported that approximately 30% of Lehel's hard currency sales are purchased by Electrolux (McMillan, 1991: 20).

Electrolux has operations in five primary business areas including household appliances, commercial appliances, outdoor products, industrial products and commercial services. Of these white goods account for approximately 75% of total sales (Annual Report 1991).

Lehel

The Lehel refrigerator company was founded in 1952 as a sheet metal processing factory, and did not develop its reputation in the area of cooling equipment until 1964. It's head office was in Jaszbereny, which is in central Hungary, and it had production facilities in several other towns across Hungary. It was the country's leading white goods manufacturer with the majority of its production in fridges and freezers and it also produced radiators and heat exchangers. It held 40-50% of the Hungarian market share and exports up to 33% of its production. It's biggest foreign markets were France, Germany, Britain, and the Benelux countries (Prospectus, 1991: 69).

Unlike many other Hungarian companies, Lehel continued to grow during the latter 1980s with 1990 production being up 18% over that of 1989. 1990 reported profits were Ft848 million on sales of approximately Ft 9 billion (ibid: 69). However, in 1989 the company found that it was losing market share as easing trade restrictions meant that its monopolistic market position was threatened. Therefore, in late 1989 the company management started looking for foreign partners (Magyar Nemzet, 19/02/92). The most logical choice being the Swedish company, Electrolux, with which it had had a long-standing relationship.

The Deal

Negotiations between Lehel and Electrolux started as early as 1989 and by the spring of 1990 Electrolux had negotiated a deal to purchase a minority share of the SOE which was under transformation. According to that deal Electrolux was to purchase an initial 26% share with an option for a subsequent majority shareholding. 30% of the firm's exports to convertible currency markets were to be purchased by Electrolux, who would manage the sales under its own brand name (HBH, 1991/1). During the negotiations the law governing the formation of the SPA was passed, meaning that the deal then had to be ratified by the SPA who acted on behalf of the state ownership rights. On August 29th the SPA intervened and, under the legal powers granted to the SPA by parliament, took the company under its control and management. According to the SPA; Following the examination of circumstances, and after a number of consultations, the SPA decided that in the case of the privatization of Lehel, sale of the whole firm is the best solution (SPA internal documents).

The reasoning behind the decision was primarily based on a desire to commit the Swedish firm to a long term engagement in the Hungarian market as well as to ensure clean-up of the environmental damage caused by 40 years of communism. It was Electrolux's desire to have 100% ownership as they felt that the only way to implement the necessary reforms within the company was by having full control and ownership. The SPA was questioned by the Hungarian press as to why it did not at least retain some ownership in view of expected income from dividends. In response, an SPA spokesman stated at a press conference:

Electrolux is firmly determined to reinvest the profits of the next five years so a minority share would only have meant some ownership rights but no dividends for a long time, and there is nothing to guarantee that the state-owned share could possibly be sold later on at a realistic price (Lehel Press Release, 05/92).

Furthermore the deal concerning Lehel employees was favourable as it fixed the rights of employees in the collective agreement and acknowledged the validity of the several hundred personal work contacts (SPA internal documents).

One key issue, for Electrolux, in negotiations was to ensure that liability for the environmental damage caused by Lehel was not passed on to the new company without some form of compensation. Due to the nature of Lehel's activities - primarily refrigerator manufacturing - the ecological situation at the Lehel site was bad. The storage of freon waste had not met international standards and a large amount of clean up was necessary to bring the site up to standard. That was not to mention the need to create new storage facilities and other necessary changes to the manufacturing process

to make it more environmentally friendly⁷⁰.

According to the deal the environmental clean up costs which were originally estimated at HUF 500 million were to be in essence paid by the SPA as they were to come out of the purchase price. Since the negotiation of the deal, the estimated costs of clean-up have risen to as much as HUF 2.4 billion, but is still believed to be covered by the purchase price and regardless is to be paid by the SPA. The actual purchase price has been kept confidential, but according to speculations it is estimated at between HUF 4-6 billion, or USD 56-84 million. Of that sum HUF 1-2 billion is to be paid to the SPA as Lehel 'Good-Will' (Prospectus, 1991: 69). A valuation of Lehel done by Ernst and Young set a price of HUF 4 billion.

The environmental clean up details require that Lehel clean up at the legal unloading sites and transport away the first part of the waste in the near future. Waste is to be transported from the illegal sites to the legal ones to be stored in accordance with techniques available in Hungary. The legal storage site would remain state property (SPA internal documents).

The deal also provided for protection of social amenities which had been provided by Lehel such as plant skating rinks, bowling alleys, kindergartens, and holiday resorts. With the exception of a zoo it is reported that Electrolux was to continue maintenance of all such extras. Apparently the zoo was donated to the local government by Electrolux.

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⁷⁰ Further discussion of the ecological problems at the Lehel site can be found in Chapter VII under the section on the ecological situation in Hungary.

Electrolux's Strategic Goal

Acquisition of Lehel, Hungary's major white goods producer, will give Electrolux a key position in the local market, with competitive production facilities for export to Western Europe (Prospectus, 1991: 69).

The purchase of Lehel was Electrolux's first investment in Eastern Europe and was designed for growth and expansion as well as to gain market share and access to Eastern as well as Western Europe. Lehel products were to be integrated into the Swedish firms international sales network.

According to an interview with the Director of Marketing, Carl Jacobson, who was brought in from Sweden by Electrolux to head up the reorganization and implement an effective marketing campaign; "the investment in Eastern Europe was a logical step, and as these markets open up all MNE's will want to get in". As Jacobsen explained, Electrolux was primarily following the other MNEs. That does not necessarily mean only white goods manufacturers but any MNEs which function in global industries⁷¹.

Hungary and Lehel were selected by Electrolux due in part to the favourable investment environment in Hungary, but the primary reason was the position of Lehel in the Eastern markets and it's corporate fit with the image of Electrolux. Lehel's quality of production was described by Jacobson as relatively good particularly by Eastern standards and Electrolux felt that it would be more efficient to purchase an existing enterprise and reform it than to start a greenfield operation. The companies first choice of entry strategy into Eastern Europe was 100% acquisition of an existing compatible enterprise.

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⁷¹ While stoves and washing machines may be considered regional products in the white good industry, refrigerators are clearly defined as global.

Motivation for the deal as outlined by Jacobson and in various press releases by Lehel was in part access to both Eastern and Western markets, and in part expansion of production facilities at a cheaper rate than could be found in the West.

Over two thirds of Lehel's products are to be exported to the West but as one press release commented:

They also do not forget that the Eastern markets are within reach. In fact that was also a motivation for the purchase ... [further] Hungary is a gateway to Eastern Europe (Company Press Release 05/92).

As the director general, Mr Szabo commented in a press release explaining the motivation for Electrolux's purchase of Lehel:

Electrolux thinks three generations ahead. Even if demand backed by funds has dropped drastically in the former COMECON countries but nevertheless a market with some 250 or 300 million people does not vanish into thin air... Although today they may not have enough to eat tomorrow they will, and the day after tomorrow they will want their food refrigerated..(ibid).

Furthermore, as this same press release states, the company has been strongly influenced by international trends which mean more saturated markets leading to an increased tendency towards concentration: "If a manufacturer means to survive he needs to expand and to invest" (ibid). Lehel was seen by the Swedish company as a perfect means of expansion in particular since Electrolux had been distributing approximately 50,000 to 60,000 Lehel refrigerators per year for many years. This meant that Electrolux had intimate knowledge of the Lehel product and also had an interest in keeping Lehel alive.

Electrolux plans to rationalize Lehel production so that fewer products are produced in greater quantities. The idea is to concentrate production on frigidaires initially while importing an entire range of complementary products. Gradually the plan

is to expand production to other products. In fact today the factory at Jaszbereny is already producing vacuum cleaners under the name Progress. Electrolux will invest up to 10.67 British pounds per year to boost local operations and raise technical levels to meet Western standards (BEE 15/04/91).

PHILIP MORRIS (US) - EGER TOBACCO FACTORY

Importance of the Case

The most interesting characteristics of this case are that it represents an example of investor initiated privatization, and that it did not involve a bid tender. The acquiring MNE, in this case, had had ties with the acquired SOE for over 10 years. With the freeing of investment opportunities brought about by the Company and Investment Acts of 1988 the firm made efforts to increase its commitment. Negotiations took place with many parties including the Ministry of Agriculture, the firm management, and the SPA. The end was a satisfactory deal.

Eger Tobacco Works

The Eger Tobacco Works reported profits of HUF 400 million in 1990 and increased exports by 400%. Exports were primarily to the former USSR, Turkey and the Far East. The firm had held a licence agreement with both Philip Morris and Austria Tabakwerke for at least 10 years. It had 25 % market share and was primarily strong in

the medium and premium markets which were expected to grow as domestic income levels grew. In this respect it was seen as being well placed for the future.

Interrelationships in the Industry

The industry was made up of four major manufacturing factories, two fermentation facilities, one monopoly distributor, and the tobacco industry (Exhibit VI-1).

Problems arose due to the fact that in the past, with everything state owned, the entire industry was run as one company. A brand for which the Eger factory owned the trademark may be partially, or wholly, manufactured at another factory. Manufacturing took place according to orders dictated by the former state owned Dohesk, which was the monopoly state supplier of tobacco products. Dohesk was transformed into a private company, HungaroTabak of which 20% ownership is held by each of the four factories.

As the individual factories were to be privatized it became necessary not only to negotiate the individual sale with the factory in question but to address the issue of gradual reorganization of manufacturing which would ultimately lead to each factory manufacturing its own trademarks and cause the least possible disruption of production in the short term.

The next issue was the new role of the tobacco institute which primarily functioned as a research and development facility for the industry. With the sale of the factories to large tobacco factories this R & D becomes redundant within the global structure of the firms. Along with this the question was: What would become of the fermenting firms and particularly the newly transformed Hungarotobak? The case of Hungarotabak was of particular interest as it was partially owned by each factory and subsequently by the new foreign owners. Therefore there was an interest in keeping it alive. It was essentially the same firm as before the transformation but it was not an effective distribution network as would be known in the West. A great deal of distribution and marketing expertise was necessary to make the firm an effective means of distribution. The question was: Who would provide this expertise? If management control of the firm were taken over by one of the western firms now in the industry will the others still maintain interest in using it as a distribution network? The potential profitability of Hungarotabak became questionable.

The Deal

Philip Morris first expressed interest in purchasing the Eger tobacco factory in

1989 but it was not until July of 1990 that any action was taken. In July 1990 the auditing firm Price Waterhouse was brought in to convert the accounts to western standards and assess the value of the firm. The deal which took over 18 months was finally signed in the end of 1991.

In the final agreement a consortium of Philip Morris and the Austrian firm Austrian Tabakwerke took over 100% ownership of the factory with Philip Morris holding 80% and Austrian Tabakwerke 20%. Philip Morris also took over management control of the new firm.

The most important factor to Philip Morris was that the deal not go to open tender. The firm felt that due to the competitive nature of that industry an open tender would harm its chances of achieving a good deal. Negotiations then took place with the Ministry of Agriculture which was primarily interested in ensuring that all of its tobacco interests achieve privatization. The Ministry of Agriculture was reluctant to grant Philip Morris 100% ownership due to limits it had imposed on the percentage of foreign ownership to be allowed in the industry. According to one source, the ministry didn't want to permit 100% ownership since that would mean approximately 30% of the industry and thus limit the possibilities for other foreign investors in the industry. At the end of negotiations it was decided that the entire industry would be split between the foreign competitors. Philip Morris would be the primary contender for the Eger factory and other factories at Pecs (BAT), Debrecen (RJR Renolds) and Sator (under tender at the time of this research) would be distributed accordingly.

The SPA decided, for various reasons including the reminder by Philip Morris

of the importance of its licence to produce Marlboro to the Eger factory, that one-on-one negotiations would be allowed rather than the traditional open tender. Philip Morris then commenced negotiations with the management and the enterprise council and subsequently approached the SPA with the deal. During negotiations the case officer at the SPA changed twice leading to much redundancy and greater difficulties in negotiations as each new case officer lacked the experience of the old one and had to be brought up to date on the specifics of the case. Furthermore, the decisions of one case officer may not necessarily hold for the second officer. As is often the case, problems arose regarding price and a second valuation was requested by the SPA carried out by Meril Lynch. This valuation was substantially higher than the Philip Morris offer and thus negotiations lead to an average of both.

Further complications came from the fact that the town authority at Eger was legally entitled to take a share in the privatized company and thus the Mayor of Eger had to be included in negotiations.

Philip Morris' Strategic Goal

The Philip Morris strategy behind the purchase of the Eger Tobacco factory can, according to Philip Morris Hungary's General Manger Greg Courtier, be summed up in two words, 'market access'. Until the 1989 legislation allowed for manufacturing investment, the only way for tobacco companies to access the tobacco market was through restricted imports or licensing agreements with state run tobacco manufactures such as the one which Philip Morris had with the Eger factory for the past 15 years.

This strategy, according to Courtier, was sufficient for premium and popular brands but did not allow for access to other markets. Due to price, premium brands reached less than 10% of the market. That left a large portion of the lower income brackets which cannot be reached through such agreements. Furthermore, due to the monopoly position of the state tobacco and cigarette distributor there was no marketing to attract potential new buyers or enter new market niches.

While Courtier admitted that Hungary is the smallest market, it is also, in his opinion, the most open and thus provided both a platform for expansion into the other former socialist states and a place to gain initial experience in a less risky environment. Philip Morris has also recently acquired a factory in Czechoslovakia and at the time of the interview was undergoing negotiations in Poland. In Russia Philip Morris was considering on a greenfield investment.

When asked about the prospects of a greenfield investment in Hungary rather than acquisition of an SOE, Courtier commented that it was the governments desire to sell off existing SOEs in the industry prior to allowing greenfield investments and therefore, until the four existing factories were privatized the government would not authorize a greenfield investment. While legally there were no restrictions in Hungary on greenfield investments, in order for an investment to be profitable it was necessary for the government to grant various tax concessions. It was most likely the withholding of such concessions which constituted the lack of authorization from the government.

The Eger factory was the logical target for acquisition as the two firms had had ties through a licensing agreement which meant that not only did Philip Morris have

internal knowledge of the firm, it had also invested in technology transfer over the years.

The role of the Austria Tabakwerke firm, which is the Austrian state owned monopoly supplier of tobacco products, was to provide expertise in distribution as well as better knowledge of the Hungarian market. Philip Morris had again had historic ties with the Austrian firm which also had a licence agreement with the Eger factory.

COLGATE-PALMOLIVE (US) - CAOLA

Importance of the Case

This case is the one of the most publicized situations where what appeared to be a good deal for all parties, did not go through. It is interesting to assess the reasons and difficulties, both official and rumoured, which lead to this unsuccessful conclusion. While in the end Colgate pulled out of the deal, the SPA was generally blamed for delaying the process during which time the attractiveness of Caola decreased substantially.

Caola

Hungary's top cosmetic and detergent firm, Caola was the monopoly supplier for personal care products such as toothpaste and a dominant producer of household chemicals. The firm had a work force of approximately 1,500 and a production range of 800 products. Capacity of its soap factory was twice as much as the entire Hungarian

market. Technical research and expertise was good, but like most Hungarian SOEs, it lacked marketing, advertising or packaging expertise to allow it to survive in this highly competitive global industry. Its competitors include such international names as; Proctor and Gamble, Colgate-Palmolive, Johnsons and Johnsons, Unilever etc.. Each of these competitors ranks amongst the top 10 advertisers world wide. Caola on the other hand has had negligible advertising efforts and did not have an effective brand image or brand recognition, even in the markets where it had been a monopoly producer. For example the brand name of one of it's cleaning detergents was BIP after the initials of the plant where it was produced. The name has no relevance to the product and had no ability to create loyalty.

Due to international competition starting in January 1991, with the freeing of restrictions on consumer goods imports, the firm's market share in the Hungarian market fell to 40% by the end of 1991. In contrast Caola held a near monopoly position in 1989 and 1990 of over 80% market share. As a result of this loss in market share the firm's turnover had also fallen by 50% since 1990 and as time passed the firm's value decreased exponentially.

Furthermore the firm has suffered greatly from the losses of orders from COMECON trade and the costs associated with the stock piling of unsold and unprocessed materials. As well, it faced increasing problems in collecting outstanding bills. According to one source; "There is regularly HUF 300-400 million outstanding in late payments, balanced by HUF 200-250 million owed by Caola to its own suppliers."

The Deal

Eighteen months of negotiations over the sale of Caola culminated in November 1991 when Colgate-Palmolive withdrew its offer to purchase the cosmetics company. The final bid was submitted in July of the same year, when the SPA sought bids in an open tender, and was reported to be the best offer submitted. Delays in valuation and decision making by the SPA, during which time Caola decreased in business value due to a loss of market, reportedly lead to the withdrawal.

The firm was initially valued at more than HUF 3 billion (approximately USD 35 million) but commercial value as of August 1991 was estimated to be approximately 60% of that. The actual financial facts of the deal are unclear. Some sources report that the actual offer price is being kept confidential while others suggest conflicting sums. According to several other Hungarian news sources the Colgate proposal was to pay HUF 1.8 billion, 50% cash and 50% in a guaranteed five year investment plan, to get 100% ownership of the firm. Further, Colgate's proposal was to have provided the capital for complete modernization with a plan to invest USD 35 million over 10 years (Nepszabadsag 05/09/91, Figyeloe 19/09/91 & 12/09/91). According to a Financial Times 'case study' the Colgate offer was USD 35 million, much of which was to be in investment guarantees, whereas the SPA was holding out for USD 50 million (03/07/92). At any rate the official word of the SPA was that the offer price was considered too low and plans were made to replace Caola's financial consultant and seek new offers. Apparently, however, few other companies were interested in acquiring the entire enterprise which may imply that the SPA will be hard pressed to find new buyers. The

management of the company were reportedly very happy with the deal as it offered both capital and future development prospects.

Caola's fall back strategy for survival involved shutting one factory and reducing the workforce of 1,500 by between 300 and 500 persons. The product range would be cut back to 650 and funds released by these actions would be used for an aggressive marketing campaign. Caola was now dealing with a much greater number of customers and needs to maintain much larger stocks in order to meet fluctuating orders. Customers often took three months to pay, so that Caola was faced with financing stocks of raw materials and products.

Colgate-Palmolive's Strategic Goal

Colgate-Palmolive's goal for initiating negotiations with CAOLA was primarily market access. Competition in the cosmetics industry is strong and with the opening up of the market it was imperative that the MNE establish a strong foot hold in the Hungarian and East European market in order to remain competitive in this global industry. The purchase of CAOLA was originally believed to have been the best way for the company to enter this market but as CAOLA's market share dropped so did the attractiveness of the acquisition.

Epilogue

Caola is continuing to lose both its market share and its best executives and competing MNEs are setting up their own distribution networks, bypassing Caola

entirely. Where Caola used to at least have distribution rights and licensing agreements with many major competitors in the industry, it has lost most of them. Colgate is considering greenfield investment to manufacture locally and avoid import tariffs. It may contract some manufacturing out to Caola. By December 1991 Colgate had formed a subsidiary, Colgate-Palmolive Budapest, to promote the firm's personal care and cleaning products. The firm is completing the construction of a factory in Poland and considering a JV in Rumania (BEE, 16/12/91: 465).

CONCLUSION: Analysis of Strategic Goals

From the above discussion of the seven case studies considered in this research, it is possible to see that the strategic goals of the MNEs do fall within the categories of either market or production orientation. Exhibit VI-2 provides a summary of these goals.

Seven of the five cases cited market access as their primary goal for investment - General Electric, Sara Lee, Electrolux, Philip Morris, and Colgate Palmolive. The remaining two were interested in the country primarily as an inexpensive source of production expansion while market expansion was considered to be a secondary goal.

**Exhibit VI-2
Strategic Goals of Cases**

General Electric:	Purchasing market share in Western Europe and access to Eastern market.
Hunslet:	Primary goal - expansion of manufacturing operations since Hungary is a relatively cheap option with decent facilities. Secondary goal -some consideration of access to Hungarian Market since monopoly position.
Sara Lee:	Expansion into Eastern Europe. Hungary to be used as a springboard into Poland and Czechoslovakia. Central location primary attraction and large Hungarian coffee market.
Sanofi:	Global expansion of production facilities and expansion into East European market.
Electrolux:	Market access and expansion of production facilities. Traditional markets saturated.
Philip Morris:	Market access. Internalization of market imperfections and tariff restrictions. Platform for expansion into Eastern Europe.
Colgate-Palmolive:	Market access and competitive pressure. Bunching of competitors.

Clearly the findings of these cases do not represent an exhaustive survey. However, they do provide examples from several different industries in the manufacturing sector as well as different countries of origin - US, Dutch, UK, Sweden, and France. As such it can be assumed that, while the sample is small, it can be considered indicative of the general strategic goals of MNEs investing in Hungary during the early period.

CHAPTER VII. ENVIRONMENTAL PROBLEMS RAISED BY CASE STUDIES

This chapter complements Chapter III which provided an overview of the investment environment in Hungary. Many of the investment environmental factors are re-addressed here based on the information gained through an examination of the seven selected cases studies. The purpose of this section are threefold: to provide some insight into the relative importance of the investment factors; to outline which factors were seen as potential impediments in the cases; and to provide insight into how those problems could be overcome.

The concerns raised in the case studies fall into four categories:

1. *Human resource* related issues: problems of the unexpected cost of labour; underemployment and the need to lay people off; management skill or the lack thereof; and different business customs and work ethics.
2. *Infrastructure and Factor Endowment* related issues: the level of technology in the production process; dramatic increases in the cost of energy; and an unsophisticated banking system.
3. Issues related to the *Political Economic Environment*: macroeconomic problems of inflation and the loss of traditional markets; problems associated with the instability of the political and legislative environments; and ecological problems.
4. Factors specific to *Privatization* and dealing with the SPA: the issues of unclear ownership rights; and delays in the processing of deals.

A detailed discussion of these concerns and how they were overcome in the cases considered follows.

HUMAN RESOURCE RELATED ISSUES

Unexpected Costs of Labour

On the issue of labour costs, while many sources cite low salary levels as an attractive point to entering the Hungarian market, these costs were seen to be deceiving in the cases considered. According to Steve Kostyal at Ganz-Hunslet:

While labour remains cheaper than in the West, social benefits and tax costs combined with lower productivity rates than in the West certainly decreases the attractiveness of Hungary as a source of cheap labour (interview).

The same sentiment was expressed by GE's George Varga who commented that: "while low labour costs may be a benefit now, the benefit is not as great when low productivity and other human resource factors are considered." He also predicted that the benefit will be short lived as labour costs are expected to increase dramatically to keep up with inflation.

Underemployment

Tied in with the problem of up to 12% unemployment is the situation of underemployment which is critical to investors seeking to purchase an SOE. When GE took over Tungsram in 1989 the total number of employees was 18,000. This was after a reorganization of the company had cut employees from a high of 36,000 in 1975. By the end of 1991 employee numbers had been cut to approximately 13,000 with more cuts expected in an attempt to make the company efficient. One GE employee estimated that

a further 25% of jobs would be cut in 1992⁷². The long term goal was to cut employment to 10,000 (FT, 26/09/90).

The Ganz-Hunslet *Joint Venture* started with over 1,100 employees plus occasional Polish workers. By 1992 this number had been cut by 60% to 454. At Lehel, labour cuts were reported as anywhere from 4,000 to 4,800 with an additional cut of 1,100 expected in 1992 necessary to bring efficiency up to EC standards (Figyeloe 19/12/91, Napi Vilaggazdaszg 30/12/91). In the Sara Lee-Compac venture it was estimated that labour cuts at the manual worker level were between 10%-12%. At the time of the interview restructuring of the administrative staff was just commencing.

A great majority of overstaffing was reported in administrative positions. In Tungsram there were reportedly 11 layers of management with an incredibly bureaucratic system. For example, "a purchase order required 24 signatures with a copy going to each person" (NYT, 16/12/90). Lehel was reported to have laid-off approximately one third of its lower level administrative workers, while those who remained received pay increases of up to 40%.

The major problems this underemployment caused foreign investors were twofold. First there was the effects of job insecurity felt by employees who feared that their jobs could be cut at anytime. Second was the high potential for rebellion against job-cuts, particularly with the strong unions and socialist tendencies left over from the previous years. According to Dr. Kund Bandi, Director of the Ministry of International Economic Relations in Budapest;

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⁷² Interview with Cameron Bird, American employee in the marketing and sales area of Tungsram.

Generally, the realization [among workers] that their jobs could be gone tomorrow is posing much tension among workers. ... Divorce rates are on the raise [and]...pressure to perform is taking its toll" (WT, 03/91)

Such rebellion could also have easily spread to nation wide strikes which could paralyse the economy. Thus far Hungary had been able to avoid strikes; the only major strike in 1991 was the taxi strike protesting hikes in the price of gas. This strike temporarily paralysed the city of Budapest but in the end the strike was not effective since the government proceeded to increase the price of gas. With raising unemployment in a country which has not 'officially' known unemployment in over 40 years this has been a very sensitive issue for foreign investors. Gyorgy Selmenczy, head of Tungsram's local union commented that:

We acknowledge that to increase productivity, some strict, unpopular measures must be taken, such as reducing the work force... but [employment and] ... wages are a touchy issues (NYT, 16/12/90).

The outcome of job insecurity for GE-Tungsram was that on the one hand "some of the most dynamic employees are leaving" (FT, 26/09/90), and on the other hand people's attitudes and worker moral was low. According to Jim Conheady, Human Resource Manager at GE:

[on the issue of lay-offs] we don't want to change the mind set from cooperation to confrontation and with all the insecurity out there this is the danger (World Trade, 03/91).

GE has been very conscious of the problems associated with the need to lay-off so many employees at Tungsram and as such has implemented many programs to soften the blow. In fact, in the initial stages no one was laid off. Rather GE opted to decrease employment through natural attrition and early retirement packages. GE has also worked

closely with the Union to ensure that the potential for strikes and other forms of rebellion against lay-offs was low. Furthermore, GE used its experience with large labour cuts in the US to provide training and relocation programs which according to GE have been successful. As Varga comments:

...the retraining and replacement programs we started a year ago are now bearing some fruit. Had we not taken steps then, hundreds would have gone onto the streets (Daily News, 29/11/92).

GE has adopted its "Transition Model", which was developed to handle large volumes of lay-offs in the US, to fit the circumstances in Hungary. The Hungarian version is called the "Workforce Enhancement Deployment Model"(Exhibit VII-1)⁷³.

Exhibit VII-1 Workforce Enhancement Deployment Model	
Main objectives:	
1.	Establish a system that identifies employment opportunities for redundant workers.
2.	Provide training to upgrade skills, enabling laid-off workers find new jobs elsewhere.
3.	Create jobs through self employment, by helping to start small businesses; laid-off workers are assisted by Tungsram's "Employee Venture Fund" which provides a qualified employee with grants and loans up to \$3,000.
4.	Upgrade the skills of the workforce through retraining and modernizing production.

Source: Business Eastern Europe 01/07/91: 204

While the success of this strategy can not be confirmed beyond the biased words of Varga, it is evident that GE has done something right since labour has been cut drastically and there have not been the major strikes and rebellion against labour cuts which were feared. As one article pointed out; the labour cuts to 13,000 also included

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⁷³ GE also predicts that this model will be adopted by other large enterprises functioning in Hungary which face the need for major labour cut backs to increase productivity.

a 500 person increase to provide necessary skills not available within the firm (BEE, 01/07/91: 204).

Unlike GE, Ganz-Hunslet adopted a policy of drastic cuts in employment at the beginning of its operations. These took place in two stages. The reason given for these drastic cuts were twofold. First, as Hunslet is a relatively small MNE, it could not afford to support the Hungarian acquisition for an extended period. Drastic means were necessary to make the firm profitable as soon as possible. Secondly, one large cut in employment levels right at the initial stages eliminated the problems of uncertainty amongst employees which could cause decreases in moral.

It was reported that the majority of manual workers at Lehel left voluntarily as they felt it was only a matter of time before they would be laid off (Magyar Nemzet 19/02/92). Those who were let go were given very generous severance packages by Hungarian standards. At Sara Lee, production level lay-offs came through rationalization of production which lead to the closure of two plants. Administrative cuts were to come soon through a massive restructuring which was to be initiated at the end of 1992. The major problem, according to Sara Lee, was the unwillingness of labour to relocate.

Lack of Management Skills

All of the MNEs interviewed complained of a lack of Western market oriented managerial skills and brought in new management teams from their other international offices, at least for the initial transition.

Human Resource teams were introduced to address problems of underemployment

and low productivity, and to set up effective human resource management systems including incentive and training programs. Ganz-Hunslet's Human Resource Planning Unit established employee evaluations based on an American model used at Duracell, and several training programs dealing with motivation and general management skills for managers. GE used its Workforce Enhancement Deployment Model to both address problems of underemployment and to set up training programs. As Jim Conheady, GE's Head of Human Resources, observed: "There was no worker training, no focus on the individual and no training plans tailored to meet group needs". Relating to marketing "basic lessons in the differences between pushing volume out the door versus focusing on customer needs and producing the right product at the right time." (WT).

There was also a lack of knowledge in the area of financial management and marketing. Steve Kostyal (Ganz-Hunslet) pointed out that management had to be taught how to use financial statements and information technology: "Managers were oblivious to financial figures". This stemmed partially from a lack of need under the old system to understand finances as well as the lack of timely and accurate information.

At Philip Morris, Greg Courtier commented on an accounting system which was manual and outdated, as it used the old Hungarian accounting standards. Also because of the interrelated nature of the industry, the financial system was interlinked with the other players in the industry leading to misleading figures. Philip Morris brought in a sophisticated accounting and information system, however, they remained concerned that they would be unable to locate Hungarians who were able to use such information effectively. According to Courtier: "it is not enough to simply bring in the system, you

must also train people to use the system and the information it produces". In the past a lot of information was processed. However, not only was the usefulness of this information questionable, most often the information was not even distributed. It was simply filed and never looked at.

The accounting system at Compack was also not computerized and it did not provide appropriate information. There was a need to adapt the system to Western accounting standards and for some time, before the Hungarian government converted to Western standards, it was necessary to carry two sets of books; one for the Hungarian authorities and tax purposes, and another for reporting to management and Sara Lee head office.

Ganz-Hunslet also introduced a new automated financial and purchasing system. As at the time of the interview, efforts had resulted in the complete computerization of the accounting system which could process monthly financial reports. Furthermore, purchasing had been computerized as well as payments. The firm even had automatic bank transfers for employee salaries.

Bill collection was another area where problems were found at Compack. The old system for collection simply required a transfer from one state account to another and overdue bills were not pursued. The company now had to enforce the collection of overdue receivables⁷⁴ and to adapt to the fact that payments from new private entities would involve cash or some similar transfer. Furthermore the volume of customers, and

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⁷⁴ Sara Lee has been able to use Compack's monopoly position particularly in the area of salt, tea, and spices to force payments of bills through a combination of withholding supply and a strong pull advertising campaign aimed at consumers requesting the product of the retailer.

thus bills to be collected, had increased drastically from about 10 to between 300 and 400.

It was found that, not only were marketing skills lacking, but because of a lack of advertising and selection for over 40 years, Hungarian consumers were less sophisticated buyers than their Western counterparts. According to research done by Sara Lee at the initial stages of operations, Hungarians had very low brand awareness and were strong brand switchers as they had never had a choice before. The major task was to create brand loyalty.

Advertising had to be more informative about the benefits of the product. The sophisticated sales techniques and advertising campaigns used in the West could not simply be imported. It was discovered that costs for dubbing and paying royalties to import an ad were greater than to make a new ad specifically targeted at the Hungarian market. The next difficulty was to find an effective advertising agency since, as was commented by Les Szabo; "Hungarians tend to think of marketing as packaging". To overcome this difficulty Sara Lee/ DE's European advertising agency formed a JV with a Hungarian company to do the advertising campaign in Hungary under the same brand names as it used in Europe (Eurobrands).

Problems in distribution came from the fact that "wholesalers in Hungary are order takers not sales people" (interview, Les Szabo). There was no problem in getting the products to the wholesalers. According to Szabo there was a surplus of trucks available in Hungary, but there was a problem with the quality and cleanliness of the trucks as well as with getting the product from the wholesaler to the retailer. Sara Lee

adopted a strong *Pull*⁷⁵ advertising campaign creating the demand at the retail level and created it's own sales and distribution network which skipped the middle man, at least for Budapest. Sara Lee guarantees delivery within 24 hours for Budapest and 48 hours for the rest of Hungary. The cleanliness problem with the trucking still existed at the time of the interview but were to be addressed through stricter selection criteria which would force cleanliness.

Business Customs and Work Ethics

According to George Varga, President of the GE-Tungsram venture, who is himself a former Hungarian:

The most difficult part is the human software ... attitudes will be the most difficult thing to change. It is not a problem which you can just throw money at (Herald Tribune 17/12/90).

A similar comment was raised by Courtier, General Manager of Philip Morris. The major problem, he said, was in changing the attitudes of the people. This was necessary for the firm to become sufficiently competitive to survive and support the major investment necessary to bring the factory up to standard. Courtier's overall impression was that the workers were willing to learn and tried hard but feared that they would be unable to meet expectations. They were uncertain as to exactly what those expectations were.

Forty years of functioning under a socialist/communist ideology and the related

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⁷⁵ Pull and Push are terms used to describe marketing techniques. A Pull strategy refers to one where the company approaches the ultimate buyers to encourage them to ask for the product thus forcing the distributor to approach the company. A Push strategy would involve marketing primarily to the distributor.

system of incentives had created many concerns in the area of human resources including; low productivity and poor work ethics; difficulty in implementation of new systems; a lack of trust and communication between management and labour; misdirected incentive systems; a lack of innovation and willingness to take initiative; and an unwillingness to take responsibility and make decisions.

Low Productivity and Poor Worker Attitudes.

Productivity levels at Tungsram in 1989 were reported to be about one seventh those of comparable American facilities and similar complaints were made by most MNEs interviewed. As the Financial Times described the business culture in Hungary: "it is activity without function or focus and rigid working practices" (FT, 26/09/90).

GE managers reported a high level of absenteeism and alcoholism (WT, 03/91) in workers as well as a negative attitude, a distinct lack of dedication to the job, and "rigid working practices where employees do anything to cheat the system" (FT 26/09/90: 12). This was evident in such 'shenanigans', as they are called by Varga, as lining boxes with rocks to increase volume output. According to GE-Tungsram's George Varga:

The mental attitudes still disturb me. Rather than can-do, it's a can't-do attitude. ... I would wish they would be somewhat more aggressively positive." (WSJE Sept 25/91) ... I did not expect them [the work force] to be as negative as they are, as down trodden. I would have thought that because of the changes everybody would be starry-eyed and enthusiastic, but they were not (American Way).

As it was pointed out by Dr. Kund Bandi, Director of the Ministry of International Economic Relations: "It used to be people would go to the workplace without having to do anything." (WT). This 'lazy' attitude towards the workplace was a primary source of

the low productivity reported by Tungsram and other Hungarian SOEs.

Resistance to Change: Difficulty in implementing reforms

Combined with the above negative attitudes and poor work ethics, GE related a distrust or suspicion, on the part of workers, of reform and unrealistic expectations of what the foreign investor could do or how soon the results would be felt. This was in evidence not only in the work force but throughout the economy and led to resistance to changes and difficulties in implementing reforms. Paradoxically, while the people had little faith in the abilities of reforms to work, they ensured that the reforms would fail by setting unrealistic expectations.

To me I get the sense that many Hungarians expect that almost overnight there will be a sudden increase in wealth and well being for everyone in the country and I think the same applies within our own business... There is a huge set of expectations surrounding the arrival of GE. They think GE just overnight literally, will change everything and everybody will be much better off. and we will have more market share and higher technology and so forth. It's unrealistic but it's hard to tell them this (Conheady, Tungsram's VP for Human resources, quoted in WT, 03/91).

GE also raised concerns regarding a fear that the foreign investor was "attempting to colonize", as Varga puts it. There is a strong nationalistic pride in Hungary and along with this comes a distrust of any foreign national which tries to force its way of doing things. Hungarians have seen other nationalities try to implement new systems before without much effect. Varga's comment on this is that: "We have to worry about a lot of tender sores ... Some people worry the Americans are trying to colonize. Making this company American overnight will not work" (NYT 16/12/90).

One of the primary outcomes of this distrust and unrealistic expectations, was difficulties with the implementation of new systems and reforms. As one American employee working in Tungsram's marketing/sales area commented: "The people did not believe that these systems would be any better than the old ones and subsequently found ways to circumvent them." This difficulty has been a major complaint of many 'advisors' sent to Hungary to assist in the transformation of SOEs bought by foreign companies. They would set up systems or give advice regarding reforms and as soon as their back was turned the people went back to the old ways.

It is natural that there be problems in the initiation of new systems since it takes time for their benefits, in terms of efficiency, to be realized. People must be trained how to use the system effectively and various bugs in the systems must be ironed out. In Hungary labour and management's resistance to change, even when it is clearly necessary that such change take place, is extremely strong.

Ganz-Hunslet found the resistance to change particularly strong from older managers who were very set in their ways. Their excuses to keep things the same were often somewhat unreasonable. For example, in response to the companies initial attempts to implement the automatic bank transfers for salary payments, the union argued that in that manner mens' wives would know exactly how much they earned and it would eliminate their possibility to keep some of their salary away from their wives, particularly that earned on overtime which their wives may not know about.

In Kostyal's opinion the only way to solve this is through gradually replacing these managers with younger and more open minded people. Furthermore, he

commented, that with time and persistence you can prove to the people that the changes recommended are for the best but it is a challenging and difficult process. You have to prove the value and often that involves a process of trial and error as the people continue with their ways until they realize that those really won't work.

A Lack of Communication and Distrust Between Workers & Management

This attitude of distrust was not only reserved for employee's attitudes towards new systems being brought in by the foreign investor. It was also seen in the relationship between Hungarian management and employees. GE managers complained of a severe lack of communication processes aimed at getting messages down (WT, 03/91) to employees and at voicing employee complaints to management. According to Varga: "Managers won't let go of anything, not trusting the people who work for them" (American Way). This point was furthered by Jim Conheady who stated that:

The biggest challenge here is the complete and utter lack of a communication process, a defined communications process, and the aim is to get the messages down through the organization under very difficult circumstances, to the least of which is a language barrier and a barrier of philosophy ... Management never communicated to workers. It was content to have ideas and plans but not tell anyone (WT, 03/91).

Misdirected Incentive Systems

Another attitude related issue mentioned by many foreign investors was a lack of pride in individual achievement. This pride in individual achievement is the cornerstone of much of western incentive programs. As the incentive system in the former economic model was cited as the major cause of the downfall of that model it is imperative that

Western incentive programs be installed⁷⁶. One of the keys to the western incentive system is making people recognize that their work makes a difference to the overall performance of the firm. If this pride is not present the implementation of western incentive programs becomes more difficult, if not impossible. According to Conheady:

I've had to explain that there will be an emphasis on achievement and individualism, that there is an equality factor that runs through American societies and so forth...Before, there had clearly been a practice of treating people as groups and not a lot of measurement of performance of individuals and what they can add to the business (WT, 03/91)... It's getting people to recognize that individual performance will be rewarded and poor performance will not (NYT, 16/12/90)...[the new system] will mean something completely different- working and getting paid according to how hard and how well (WT, 03/91).

A Lack of Innovation and Willingness to Take the Initiative

Connected with this issue of incentives was one of the most common complaints of Western investors; the labour force and management lacked the ability to take the initiative and there was a distinct lack of innovation at any level. This lack of innovation and initiative has been described as one of the keys to the downfall of the old economic model. According to Varga this lack of initiative is the single most distressing factor.

It is not the low level of productivity or management, which is exasperating, but that the last decades killed the initiative of people. Everyone is following orders, there are few who feel an inside motivation to create something new... New ideas were discouraged there was very little initiative and zero sense of ownership (IHT, 17/12/90).

The problems associated with this lack of initiative and innovation are very clearly

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⁷⁶ An exception might be argued to be the Japanese manufacturing model of small group organization. However both systems include merit pay based on individual, as well as group achievements.

demonstrated in the following excerpt which speaks of the experiences of GE-Tungsram's technological manager:

Every morning Mr Gadra (GE's American manager directing the technological shift) gathers his information-systems managers to see what can be learned from problems of the previous 24 hours. "What I often get is an eloquent, detailed description of what went wrong and what the current situation is, but an absolute silence about a plan to go forward to solve it. Day in and day out, you go back to the fundamentals. You keep reinforcing, reinforcing. As in athletics, you keep raising the bar of expectations. Some days you go out and see you can't even match yesterday. So you go back again to the fundamentals." (WSJE, 25/09/91).

Unwilling to accept Responsibility and Make Decision

Related to a lack of innovation and initiative was an unwillingness to accept responsibility and to make decisions. According to Karoly Vigh, a Tungsram employee:

I wanted to tell my boss everything I was doing and find out his opinion of everything ... What I found out is that my boss doesn't want to know everything I'm doing. He tells me: 'If I have to make all your decisions for you, one of us isn't necessary' (WSJE, Sept 25/91).

The Hungarians expected a strict top down decision making system where the 'plan' dictates the outcome of all decisions and very little is left to the discretion of the lower level management. On the other hand, Western management trends have been towards decentralized decision making. This conflict creates problems as both the foreign investor and the Hungarian employees had to learn to adapt. As Varga pointed out:

The day we walked in here, they wanted to see a book saying "this is exactly what we are going to do by this date" ... The Hungarians wanted to know exactly five years from now how many people we will have, how much investment etc. (a comment by Varga quoted in American Way).

At one orientation day put on by a large Western accounting firm which was

recruiting for prospective employees, the emphasis was on telling people that it was alright to criticize. Training in that company included how to make decisions and to ask questions, which was in fact a major issue to that firm. Their experience had been that the Hungarian people were very reluctant to ask questions or to make decisions.

FACTOR ENDOWMENT AND INFRASTRUCTURE RELATED ISSUES

Inconsistent Levels of Technology

As mentioned in Chapter III the level of technological advancement in production facilities varied depending on both the industry and the country. In fact in some case it could vary substantially within the company and even within one production line.

According to Stephen Kostyal; technology at the Ganz-Mavag facilities were in relatively decent shape. Ganz-Hunslet had not had to invest heavily in machinery and any of the work for which Ganz was not up to par technically was contracted out to other Hungarian firms and suppliers who could meet the strict quality restrictions put on them by Hunslet. Ganz-Hunslet boasts to be the only Hungarian company to have received the British quality standards award, BSI 5750, for operations which meet British, and thus international, standards in all areas. As such the firm has also required to demand the same quality from its suppliers. Due to the severe recession in Hungary, and world wide, Kostyal described the industry as a buyer's market and as such the firm was able to contract out much of its work for cheap prices while at the same time maintaining strict controls of the quality of the products supplied.

Resolution test chart showing patterns of vertical and horizontal lines with numerical labels: 1.0, 1.1, 1.25, 1.4, 1.6, 1.8, 2.0, 2.2, 2.5, 2.8, 3.2, 3.6, 4.0, 4.5, 5.0, 5.6, 6.3, 7.1, 8.0.

MICROCOPY RESOLUTION TEST CHART
NATIONAL BUREAU OF STANDARDS
STANDARD REFERENCE MATERIAL 1010a
(ANSI and ISO TEST CHART No. 2)

This was not the case according to GE's George 'arga, who pointed out that, although there were some modern machines at the Tungsram plant, studies showed great wastage and low productivity. In fact GE estimated that the productivity of the Hungarian facilities was approximately 40% that of Western Europe. In the first two years GE invested over USD 55 million in updating the technology and modernizing existing facilities (Figyelo 02/01/92).

At Philip Morris, Greg Courtier's comment on the production facilities was that; while the equipment at the Eger factory tended to be dated, it had been well maintained and regularly updated when necessary. His main concern in updating the facilities was not to jump too far too fast technologically. In his opinion it is useless to bring in tomorrow's technology if your workers have yesterday's training and cannot use the equipment.

The situation at Caola was mixed. While some of the equipment was said to be relatively modern and in good shape (5-10 years old) other facilities were basically obsolete and in the words of one Proctor & Gamble representative; "should be condemned"⁷⁷. He pointed out that the factory was in a very bad state of repair and was not appropriate for manufacturing. The equipment was relatively good and they would have bought just the equipment and might have taken some of the employees since productivity appeared to be good but as an entire entity it was not a viable option.

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⁷⁷ Informal interview with P&G production manager.

Dramatic Increases in Energy Costs

Availability of energy was not mentioned as a major concern for the case studies considered, however the dramatic increase in energy cost resulting from the conversion to market prices after the collapse of the COMECON trading block was mentioned. As George Varga of GE pointed out:

rapid disintegration of the COMECON ... [and] the shift to hard currency accounting in intra-East European trade has resulted in higher than anticipated hard-currency energy costs (BEE 19/01/91: 12).

This had a profound effect on production costs at Tungsram, as profits have not lived up to expectations, and has led to a slow down in their investment plan. This would not be considered a major concern for investors considering an investment after 1990 but it was a problem for those who invested early and did not build the dramatic increase into cost expectations.

Unsophisticated Banking System

According to George Varga: "For the time being only a few people understand that banking activity is a service and that speed and accuracy are of outstanding importance" (Pesti Hirlap 07/12/91). Varga went on to cite such problems as delays in inter-bank transfers being unacceptable. On the other hand, in Steve Kostyal's opinion, while there were still many difficulties in the banking system, including delays and tendencies to lose international bank transfers for extended periods, the system was at root quite good and it had improved dramatically since the time when the company first started operations. After some initial frustrations, the company was able to initiate an

automatic bank deposit pay system and has converted all of its bill payments to bank transfer. Kostyal's advice was to simply have a little patience and you could get everything done.

Underdeveloped Telecommunication, Transportation, & Utilities Systems

This was an issue raised in all of the cases considered. It was mentioned as a frustration but appeared to be accepted as part of doing business in emerging economies such as Hungary. Each of the managers interviewed said something to the effect of: 'of course infrastructure is a major problem, getting telephone lines and roads put in can be a major frustration, but things continue to improve in these areas and it is all part of doing business here'.

CONCERNS RELATED TO THE POLITICAL ECONOMY

High Inflation and Lack of Currency Devaluations

As George Varga, CEO of GE-Tungsram states:

On some of our export markets, owing to keen competition, commercial profit margin is so small that under Hungarian cost/price conditions export isn't profitable (Figyelo, 02/01/92).

On the other hand, according to the managing director of Ganz Hunslet, Kostyal, inflation has not been a major issue. What it did, however, was prompt the company to build inflationary considerations into the payments schedules of bid tenders. Rather than having small down payments and large lump sum payments at completion, meaning the

firm must resort to bank and credit financing for production at a rate of up to 34%, the company decreased the bid price on the basis of the buyer paying monthly instalments thus financing production as it goes. Kostyal commented that while it is often difficult to get Hungarian buyers to accept and understand such alternative financing options the firm has succeeded in the past through much persuasion. As Varga estimated:

The company [GE-Tungsram] suffers from inflation and devaluations considerably lagging behind. Each percentage of difference ... costs Tungsram \$1.50, it totals \$60 million for the past two years ... If devaluation of the Forint had conformed to the rate of inflation ... [Varga predicts] we would have closed the year [1991] most probably with a profit (Figyelo, 02/01/92).

The effect of this is to decrease the attractiveness of exports as a market for production. In fact Tungsram, for example, withheld exports in 1991 of up to USD 20-25 million according to its estimates.

Loss of Traditional Markets

One example of difficulties arising from the break-up of COMECON was seen in the case of Sanofi's acquisition of Chinoin. Much of Chinoin's sales had gone to the former USSR and a deal had been signed for over 400 million convertible rubles worth of products were sold to the Soviet government in 1990 and USD 100 million was agreed to for 1991. The company had not commenced deliveries on this USD 100 million by mid 1991 since it could not secure guarantees for payments. Therefore Chinoin stockpiled products which not only decreased sales revenues but also increased inventory costs. As of early 1991 over USD 10 million worth of goods were stockpiled awaiting shipment (Figyeloe, 18/07/91).

Lehel-Electrolux also realized a dramatic decrease in sales as a result of the loss of the COMECON market. The Electrolux solution was to integrate Lehel into its international sales network under the name Zanussi from Lehel. GE-Tungsram had to suspend production for one week in March of 1992 due to its stockpile mounting as a result of the loss of market.

Since Ganz-Hunslet's products were considered a one time purchase rather than a repeat purchase product, the collapse of the COMECON did not affect the company directly. Indirectly it has at least temporarily lost a great potential market. At the time it did not hold any Eastern orders beyond those for spare parts. Indirectly it has meant that the firm must generally seek other markets for its orders. According to Kostyal, the last big order from the former USSR was back in 1987 but in the hey-day of the COMECON trading system the former USSR could account for an order of up to 4,000 rail cars⁷⁸.

Government Attitudes Towards FDI

On the surface, and in official doctorates, the government extends a welcome hand to foreign investment in Hungary and in general this positive attitude is strong. However, some foreign investors and consultants have complained of a lack of willingness on the part of government officials to meet with prominent Western businessmen as well as a lack of respect for these top executives. For example, the CEO

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⁷⁸ Today the majority of Ganz-Hunslet's order are either domestic or from such countries as Egypt and Malaysia. Sales to the West have generally been limited to the company providing more of a distribution agent role where it finds buyers and suppliers for products which it doesn't necessarily produce primarily in the speciality products markets.

of General Electric George Varga, was unable to get an interview with Kadar and has still not been able to get a meeting with the prime minister. At a dinner party hosted by Tungsram for the Stanford Research Institute for the purpose of introducing several top foreign investors to Hungary, the majority of the government representatives who were invited did not attend (Figyelo, 02/01/92). Similarly at the SPA when the CEO of American Express wanted an interview with Lajos Csepi, the head of the SPA, this task was delegated down to a more junior level well below that warranted by such a top business executive. As an executive at Guardian Glass commented:

On the part of my business partners I hear more and more often: 'this government doesn't understand or doesn't like businessmen (Figyelo, 02/01/92).

It is the opinion of many foreign investors that it was this lack of willingness to meet with top businessmen which ultimately lead to the failure of the Colgate-Palmolive agreement to purchase Caola. Colgate was left out on a limb for a long time with the government not willing to provide adequate feedback to maintain their interest.

This frustration on the part of these investors in trying to meet with government officials does not necessarily indicate that the government has an unfavourable attitude towards FDI. In fact the extent of incentive programs designed to encourage FDI would indicate the opposite. What this frustration indicates could be considered more as a result of the inexperience of the government in dealing with private foreign investors.

Concerns in the Legislative Environment

While Hungary professes the most advanced legislative framework for investment,

in the words of GE-Tungsram's George Varga:

Official declarations shall be distinguished from governments actual behaviour. While the former gives rise to the belief and confidence in the foreign businessman, the latter often causes disappointment (Figyelo, 02/01/92).

Varga also pointed out that there was a need for greater dialogue between those creating legislation and business people and/or experts. According to his opinion, while there were perhaps too many interest protecting organizations influencing legislation, these organizations were not in representing the right interests. For example there was little representation from exporters unions (Pesti Hirlap 07/12/91).

Severe Ecological Problems

Of the cases considered for this study, the only one involving significant ecological concerns was the privatization of LEHEL. The first step in the privatization process, on the part of Electrolux, was to have an extensive environmental study performed. Electrolux then was able to negotiate with the SPA to have such costs deducted from the purchase price. With a potential hidden cost which is that high, clearly it is imperative that investors engage in some form of environmental assessment during the due diligence process.

The initial environmental protection survey was performed by the Fersenius company who was commissioned to look at the company plants of Lehel in Jaszbereny, Jaszboldoghaza, Torokszementmiklos, and Budapest. According to this report:

Among the examined sites oil pollution was found in Jasz Boldoghaza in a smaller area, the extent of which is a subject under further examination. In Jaszarokszallas, oil pollution, other pollution caused by organic

solvents, pollution of water sources, inappropriate burial of barrels containing waste, and other pollution originating from inappropriate storage of dangerous waste were found.

The situation is the most serious in Jaszbereny. The experts examined five illegal unloading sites, a waste store legally provided for Lehel, and a site where Lehel's waste and the town's communal waste were deposited together. In this last case it cannot be stated yet to which extent Lehel and the municipality are responsible, but it appears to be basically a communal waste problem. At the illegal unloading sites, and in the area of the factory, serious pollution in the form of organic solvents, oil, and metals considerably exceeding German standard levels can be found, mainly due to inappropriate storage and careless handling. At the 12 wells in the surrounding district significant pollution was found. In certain cases the pollution had spread under the buildings as well (SPA documents).

While the deal stipulated that the price of environmental clean up would come out of the purchase price, the costs as of January 1992 have reportedly run as high as HUF 50 million (USD 662,000) and Electrolux has been reported to be seeking further financing to continue work (BEE 1991: 47).

PRIVATIZATION AND SPA RELATED ISSUES

Uncertainty Regarding Ownership Rights

Uncertainty on the part of the MNE in terms of who had the right to negotiate the privatization deal, company management or the SPA, and with the SPA taking over the management of the SOE were major issues in the cases of LEHEL, Compack, and Chinoin.

In the case of LEHEL a deal was struck with management then, when they sought SPA approval, the SPA vetoed the deal and took over the management of the firm. As

it happened the final deal was in fact preferable to the MNE. However, that is not always the case. When Compack was privatized, the end deal did not include the same foreign investor as the deal negotiated with the company. In this case, initial negotiations took place between Compack and a German company TSCHIBO with whom Compack had had close ties in the past. This prompted a complaint by other potential buyers and led to the SPA taking over control of the company and firing the general manager. Subsequently there was an open tender bid and the winner, Sara Lee DE, was neither TSCHIBO nor the firm which initiated the complaint, Nestle.

Delays in Negotiating and Processing Deals

While legislation says the decision process should take only 30 days the it could always be delayed by the SPA asking for further information or revisions. The most prominent reasons given for delays in the processing of cases through the SPA were:

- employment and organization structure related issues - understaffing, high turnovers combined with a lack of training and uncertain employment practices;
- political influences on the actions of the SPA which lead to impotence when it comes to controversial issues; and
- disputes over price due to difficulties associated with the valuation of the company.

One of the most publicized examples of how delays at the SPA could wreak havoc on potential acquisitions is the case of Colgate Palmolive's aborted attempt to purchase Caola, a major Hungarian cosmetics producer. The SPA was accused of using delaying tactics in an attempt to prompt Colgate to upping its offering price. This tactic had been

successful in the privatization of Compack where it was able to get a substantially higher price from a competitor by waiting and inviting further tenders.

On the other hand the SPA has also been accused of simple laziness. As one foreign investor commented: "Apparently the report submitted by Colgate was too long and the case officer did not want to be bothered to read it. He simply kept putting it at the bottom of the pile". While that comment is extreme it is indicative of the opinions of investors. Another person thought this case was a somewhat controversial one in that it involved a substantial amount of FDI and thus the SPA was simply avoiding making a decision which might be politically dangerous. The SPA claims that they were flexible to Colgate's bid however, as time passed, disagreements arose regarding the value of the firm. Apparently the SPA would not take into consideration the falling value of the firm resulting from losses in market share and a deteriorating financial position.

In the case of the Chinoïn privatization, negotiations were held up for an extended period as the three parties -the state, the company management, and the investors- altercated over the true value of the company. The company's management believed that the firm could perform much better than early valuations predicted, while Sanofi was sceptical about the ability of the venture to turn a profit even at the lower valuations. The SPA was interested in maximizing the profits in the short term and encouraged a higher price, regardless of the potential effect that may have had on long term growth. The interests of the state would encourage a valuation based on low levels of R&D and investment in the earlier years thus leading to higher profits and a higher value, whereas Sanofi's interests would call for lower predicted profits in the short term, thus decreasing

the price.

In the Philip Morris acquisition of the Eger Tobacco factory, the SPA case officer changed three times meaning that negotiations had to start from scratch three times leading to unreasonable delays. In total the negotiations of the purchase took over one and a half years. Similar delays were reported in the privatization of Chinoín when there were discrepancies in the value of the firm between the investor and the SPA but also the management had another impression.

CONCLUSIONS: Investment Environment Concerns and Solutions

The findings of the case studies regarding problems faced in the negotiations and operations of investments showed a substantial variance between the cases. Much of this variance can be attributed to the differences in the nature of business carried out by each case as well as the stage in development of the venture at the time of the research. The findings depended largely on the availability of information and the willingness of the MNE to discuss the venture as well as the role of the manager interviewed in this research. Due to the publicized nature of the GE venture there was a great deal of information available whereas in other cases often the findings were limited to the information which was available. Exhibit VII-1 shows a summary of the cases and the concerns they raised according to the categories used above.

Exhibit VII-1 Summary of Case Findings				
Company	Human Resource	Factor Endowments /Infrastructure	Political Economic	Privatization
General Electric	• Labour cost • Underemployment • Mgmt Skills • Business Customs	• Technology • Energy • Banks • Telecom/Transport	• Inflation • Loss of Mkt. • Govt-FDI • Legislation	
Hunslet	• Labour cost • Underemployment • Mgmt Skills • Business Customs	• Technology • Banks • Telecom/Transport	• Inflation • Loss of Mkt.	
Sara Lee/DE	• Underemployment • Mgmt Skills	• Telecom/Transport		• SPA takeover
Sanofi			• Loss of Mkt.	• Delays
Electrolux	• Underemployment	• Telecom/Transport	• Loss of Mkt. • Ecological prob.	• SPA takeover
Philip Morris	• Business Customs	• Technology • Telecom/Transport		• Delays
Colgate Palmolive	• Underemployment	• Technology		• Delays

The General Electric and Hunslet cases were the most established and much of the discussion in those cases evolved around the operations of the venture with strong emphasis on human resource factors and problems associated with the lack of factor endowments. The acquisitions in these cases took place prior to the establishment of controls over privatization and the formation of the SPA, therefore the problems associated with negotiations of the purchase were not of as great interest.

In the cases of Sara Lee/DE, Lehel, Sanofi, and Colgate the issue of most interest were the problems encountered in negotiations with the SPA. These represent some of the first privatization cases to be processed through the SPA. Each of these cases provide examples of the problems surrounding dealings with the SPA. At the time of

research, these ventures had not been in existence for as long as the first two ventures and as such the experiences associated with their operations are not as extensive. In the case of Colgate the deal failed so that operations were not an issue at all.

Philip Morris is one of the youngest ventures considered and demonstrates how many of the problems associated with delays and uncertainty of ownership could be overcome through patience and ensuring that all parties with interests in the deal were involved in the negotiations. Many of the concerns regarding human resources and factor endowments raised in the first cases were also mentioned by Philip Morris showing that the problems remained and a quick solution to those problems was not possible.

Given the above qualifications on the case study findings; what does this say about the relative importance of the environmental factors and how problems can be overcome? Exhibit VII-2 provides a review of the case study findings regarding the problems raised in Chapter III's assessment of the investment environment. Column one of the exhibit outlines the problems raised in Chapter III. The second column provides an indication of the importance of each problem by considering their relevance to the case studies as major impediments. Column three outlines the ways which the MNE is able to circumvent problems based on both the findings of the case studies and the conclusions of the literature review in Chapter II. While the findings of each case study individually do not necessarily give an adequate picture of the importance and possible solutions of all issues, if the findings of all the cases are considered together there is relatively clear understanding of the issues.

Exhibit VII-2 Conclusions of Investment Environment Concerns and Solutions		
Problems outlined in Chapter III	Raised in Case Studies?	How problem could be neutralized or solved by MNE.
Factor Endowments Unexpected labour costs and low productivity of labour. Lack of capital Increases in energy costs Inconsistent technology Small market size, low income Managerial skills	Yes No Yes Yes No Yes	Must accept costs but can bring in Human Resource Management team from parent company to increase productivity. Cut volume of labour to cut costs and factor extra cost into original cost estimates. MNE can source capital internally or from foreign banks based on parent company guarantee. Not really an issue for investors prior to 1990. Increased costs should have been predicted and factored in. Import technology and expertise from parent company. Market part of global network and platform for exports. Import skills from parent company and train locals.
Infrastructure Unsophisticated banking system Telecommunications Transportation and utilities	Yes Yes Yes	Can source most capital needed internally and can work with banks to help develop. Accepted as part of doing business there. MNE can build its own local roads but major transportation difficulties are accepted as part of doing business there.
Culture Work ethics and business customs ingrained from 40 years of communism. Unknown language	Yes No	Import people from parent company to train and initiate exchanges of managers. Import ethnic Hungarians who left in 1956 revolutions in management team and train Hungarians in English.
Information	No	MNE can create own information network

Exhibit VII-2 Conclusions of Investment Environment Concerns and Solutions		
Problems outlined in Chapter III	Raised in Case Studies?	How problem could be neutralized or solved by MNE.
Macroeconomic Inflation and lack of currency devaluations Loss of traditional markets Unemployment/ Underemployment	Yes Yes Yes	Incorporate in costs but can't control Incorporate into new sales network. Bring in human resource team and retrain for other jobs.
Political factors Scandals and nationalist tendencies Attitudes towards foreign investors of some government personages.	No Yes	Can't Control Form lobby groups to push the interests of the foreign investor and try to create working relationship with government.
Legislative Factors Legislation passed in haste, lack of administration, not considering all factors. Unstable.	Yes	Can't control but can attempt to influence through interest groups and creating working relationship with government.
SPA related Issues Unclear ownership rights and conflicting interests. Delays in processing deals through the SPA	Yes Yes	Ensure that all possible parties concerned are involved in negotiations from the start. Can't control. Must be patient and try to work with the SPA.

From the above table it is evident that human resource related issues were the most crucial concerns. The MNEs faced the need to lay-off significant numbers of employees and train the remaining ones in Western business techniques. Dealing with the effects that 40 years under communism have had on the Hungarian people was a major concern in these cases. Attempts to address these concerns in each of the cases considered involved the import of management teams from the MNE's other corporate

offices. The details of each company's strategy towards human resources differed based on the perceived severity of the situation and on the MNE's global human resource strategies.

Of the remaining problem areas, the MNE could circumvent or neutralize most problems surrounding infrastructure and factor endowments through internalization and global sourcing within the corporate network. The exceptions to this include; day do day domestic banking needs, telecommunications, transportation and utilities. These problems must be accepted by the MNE as part of doing business in an *emerging*⁷⁹ economy. Issues related to the political economic situation and the privatization process fall outside the control of the MNE and, with the exception of overcoming the loss of traditional markets by incorporating the new venture with the MNE's global marketing network, the MNE can do little to resolve these problems. Beyond being patient, the only thing MNEs can do to alleviate these problems is to develop relationships with people in government and ensure that the interests of MNEs are considered as the political, legislative, and macroeconomic environments develop.

What message does this analysis give to future investors considering acquisition in Hungary? The initial assessment of the investment environment would imply that there were many problems associated with such investments and therefore investors should be very cautious. However, the findings of the case studies demonstrate that many of these problems can be overcome and are not as critical as they would appear at first glance. The key problem is in a need to change the attitudes of people both in the

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⁷⁹ The term emerging economy has been used to describe the situation in the former socialist states. They are essentially developed economies which are emerging into the global market economy.

target SOE and in the agencies and institutions which the investor must deal with.

In the negotiations of the deal it is important that the investor be patient and thorough. The MNE must ensure that negotiations involve all parties who have an interest in the deal and confirm where the ultimate power to make decisions lies. It is important to foster good relations with the SPA and the company management and to double check every point. Contrary to what has been a popular belief among investors, there are no "quick buck" deals in Hungary. In the words of Steve Kostyal; "If you are not in for the long term and willing to take a loss in the short term, there are no opportunities in Hungary."

The message for the MNE in the operation of the new venture is again that human resource problems are the key and as Varga said: "It is not something you can just throw money at". Cross cultural awareness and training is crucial to the success of the new venture. This awareness and training must be both on the side of training Hungarian workers in the ways of Western management and work ethics, and ensuring that the foreign managers have an understanding of how things are generally done in Hungary and how to adapt to them. A good deal of Hungarian business is based on personal contacts and it is imperative that foreign managers also develop good relations with the other relevant actors in the industry including government officials. Finally, the experience of these cases confirms the need for the MNE to import expertise, technology and capital.

VIII. THE THESIS REVISITED

The strategic goals of MNEs acquiring controlling interest in former state owned enterprises in Hungary's manufacturing industries can be categorized as either market seeking or production oriented. Market oriented goals are more prevalent. MNEs are pursuing these goals despite the many difficulties associated with an unstable investment environment and negative legacies of the communist period.

The analysis of the seven case studies selected for this research has provided evidence to support the postulated thesis for the early years of transition in Hungary. The first two chapters introduced the topic and provided the development of the hypothesis based on a review of the literature available dealing with the issues of FDI activities of MNEs. The next three chapters laid the ground work for selection and analysis of the case studies in Chapters VI and VII.

Once the thesis had been developed, Chapter III demonstrated that the investment environment in Hungary was in fact unstable and that there were several negative legacies of the communist period which the MNE had to consider in the investment decision. Instability in the investment environment stemmed primarily from the political economic factors:

- Rapid changes taking place in the legislative arena;
- Macroeconomic problems caused by the reform efforts to convert the economy to a market oriented system; and
- Political concerns as the concept of democracy is young and the actors are going through a learning process.

This instability was in part caused by, and complemented by, the negative legacies inherited from the communist system which included:

- The attitudes of the people and work customs;
- A lack of knowledge in the areas of western business techniques;
- Inadequate infrastructural systems such as telecommunications,

- transportation, utilities, banking, and capital markets;
- Low productivity and inconsistent levels of technology;
- Macroeconomic problems such as the high level of international debt and the loss of traditional trading markets;
- A legislative framework which is not effective for a market economy; and
- Severe ecological problems.

Chapter IV provided an assessment of the privatization program in Hungary and outlined conclusions regarding the problems inherent in the system. This chapter concluded that problems with the privatization system included:

- Delays caused by a bureaucratic system, understaffing, problems with valuations, and political influence;
- Perceived unfair practices in tender process;
- Hostile attitudes of employees towards outside consultants and investors;
- Uncertainty regarding decision criteria and procedures; and
- A lack of available information.

In Chapter V it was demonstrated that, regardless of these facts FDI continued to flow into Hungary and that Hungary continued to attract more FDI than other countries in the area. Furthermore, that chapter pointed out that the lions share of FDI in Hungary was invested in the privatization programs.

With the background for analysis established, Chapter VI went on to provide an analysis of the strategic goals of the MNEs considered in the research and concluded that the strategic goals of the MNEs in the cases considered could in fact be categorized as either market seeking or production oriented and that market seeking goals were more prevalent. Of the seven cases considered five cited market access as their primary goal for investment. The remaining two were primarily interested in an inexpensive source of production expansion, however, they did consider market expansion as a secondary

goal.

Finally Chapter VII provided an analysis of the specific problems raised in the case studies and how the MNEs were able to overcome some of these problems. The conclusions of Chapter VII showed that human resource related issues were the most critical to the investors and could not easily be resolved. The MNEs were able to overcome many of the factor endowment related problems - what Porter would have categorized as basic factor endowments⁸⁰ - through internalization of market imperfections and global sourcing through the MNE's international network. This left those factor endowments which Porter would classify as advanced -telecommunications, transportation and utilities. The remaining factors or issues included political economic concerns and problems associated with the privatization process.

Given that the findings of the study support the basic thesis, what does this analysis say about the primary research question posed in Chapter I. Specifically: Why are MNEs investing in the privatization of Hungary's SOEs despite the problems? The analysis of the case studies' strategic goals said that market access was the primary goal. However, given the small size of the Hungarian market and the low income levels, what is it that makes the market so attractive to investors that the perceived benefits outweigh all of the problems which come along with the investment. Due to the central location of Hungary, some mention strategies for the use of the Hungarian market as a platform for expansion into the rest of Eastern Europe, Western Europe, and even the Middle East. But then the question becomes why Hungary and not the other countries in the

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⁸⁰ Porter discusses these in his work on Competitiveness of Nations which is outlined in Chapter II.

area. In answer to that, it has been pointed out that the Hungarian investment environment is the most stable and most attractive of the former socialist countries therefore making Hungary the logical choice.

It is interesting to note, however, that the majority of the MNEs who have invested in Hungary have also considered investment ventures in other countries in the area. The strongest argument explaining the expansion of MNEs into the Hungarian market stems from the need for the MNE to have operations in all important markets and Hungary represents a market of relatively sophisticated buyers who have been deprived of quality products and selection of goods. MNEs are primarily considering the Hungarian market because it is a new emerging market which provides great sales opportunities particularly for industries which face saturated markets in the majority of the Western world.

APPENDIX A

People Interviewed:

Simon Allen
Price Waterhouse, Budapest
Head of Corporate Finance

Michael Athanason
International Valuation Services Inc.
General Manager

Robert Bau
Consultant
AB Lux Hungary

Dr. Judith Bezeredi
Operations Manager
Regional Environmental Centre

Cameron Bird
MBA Enterprise corp.
Representative working in GE-
Tungsram

Christopher E. Black
NewEraInvest Ltd
President
-head of a small foreign investment
brokerage company who represents
the interests of various American
Companies in Hungary.

Michael Carter
VP First Hungarian Investment
Advisory Fund.

David Cooke
Manager
Ernst and Young

Kevin Crawford
Price Waterhouse, Budapest
Manager Auditing and valuations

Lawrence E. Cohen
Environmental Attache
American Embassy, Budapest

Gregory Courtier
General Manager
Philip Morris Hungary

Margaret Desze
Price Waterhouse, Budapest
Corporate Fiance
-worked extensively on the Philip
Morris Case

Jean-Yves Dionne
Canadian Commercial consul

Dr. Janos Dolf
Attorney at Law
-Independent, Hungarian attorney
who is also the representative for
AUTOKER.

Dr. Gerd Duckelmann-Dublany
Austrian Commercial Attache

Bart Edes
Senior Research Fellow
Kopint Datorg
Institute for Economic and Market
Reserch and informatics

Istvan Elias & Zsuzsanna Bertalan
Dunaholding Rt
-Firm acts primarily in the interests
of firms through spontaneous or
self-privatization programs.

Tivadar Faur
Coopers & Lybrand
Corporate Fiance Services
-used to work with the SPA in
valuations, now is used by Coopers
primarily as a contact with people at
the SPA who they feel they can
trust.

Dr. Eleonora Fodor
Legal Advisor, Privatization manager
Pri-Man Ltd.

Andrew Gollner
Hill and Knowlton International,
Hungary

Neil Haynes
Coopers & Lybrand
VP Corporate Finance

Graham Hill
Property Executive
Investor RT/CP Holdings

George Hollo
SPA PR directorate
-Canadian advisor

John Kolozs
President
International Management Services
Budapest

Stephen Kostyal
Executive Director
Ganz-Hunslet Rt.

Roger Lang
Deputy General Manager
Country Fiance Manager
Digital Equipment Hungary

Peter Maduar
Baker & McKenzie
Partner
-Responsible for contact with the
SPA dealing primarily in the large
privatization such as found in the
first and second privatization
programs.

Andre Mecs
Fasken Martineau Davis,
Advocats
-Former President of Canadian
Hungarian Chamber of Commerce

Jozsef Menyhart
Joint Venture Association
Hungarian Chamber of Commerce

Martin Middlehurst
Partner KPMG

Peter Morenth
Counsellor
State Property Agency

Agnes Panczel
Tungsram Co. Ltd.
Press Secretary

Bele Papp
Managing Editor
Business Eastern Europe

Keve Papp
Correspondent
Business International

Zoltan Piroksa
Coordinator
American Chamber of Commerce in
Hungary

Dan Ramser
Ford

Julie A Rowney
Dean of International Management
Centre, Budapest.

Thomas R. Stanton
Tungsram Co. Ltd.
VP Marketing
-was one of the original people sent
over by GE.

Kristin Stolen
AGA gas

Les Szabo
Commercial Manager
Household and baby care
Compack Douwe Egberts Ltd

Dr. Peter Szirmal
Co-Chairman
National Association of Entrepreneurs

Robert Toltzman
CEO
International Valuation Services Inc
-Came to Budapest in 1988 and
worked on first business valuation.

Lars Werner
General Manger
AB Lux Hungary

Gabor Varkonyi
Chief of Section
Ministry of International Economic
Relations

APPENDIX B

Employee Stock Option Plans

Along with the direct privatization programs brought out by the SPA, other privatization related programs, dealing primarily with the issue of ownership claims, have come to being such as compensation for employees in the form of Employee stock option plans and a compensation program for former owners of property who suffered losses through the nationalization of the economy.

"In order to deal with the existence of the Enterprise councils, the government decided that those corporations which were previously under worker management, could participate in a modified type of Employee Stock Ownership Plan (ESOP). According to this program, 20% of the income from privatization would have to be rolled back into the company. This served two purposes: one, to strengthen the company's cash flow, and two, part of the money would be used for allowing employees to purchase up to 10% share at reduced cost." (Hollo, 1992: 16)

In fact, there are several different legislations governing, or allowing, different forms of employee ownership. The Company Act of 1988 allows for the issues of preferential or free shares to employees. The Transformation Act of 1989 can make these types of grants obligatory in certain circumstances. The Property Policy Directives of the SPA allows it to sell up to 15% of shares or business units of a company to employees by means of granting them up to 50% discount on the price. Furthermore, property can be acquired by selling property bonds &/or giving them away free of charge, transforming them into shares or business units at a later date (SPA2, 1992: 76).

In the majority of cases to date, where employees have bought shares in companies this has been limited to less than 10% of the company and have accounted for

approximately 4.3 billion forints of the SPAs sales, or some 30 transformation cases. In the future the participation of employees in transformation and privatization is expected to increase significantly.

The pending Employees stock option program (ESOP) will provide further opportunities for employee ownership. However, depending on the form of the company, its ownership structure, and its financial structure concessions available under such a program may be different (SPA2, 1992:77).

Because of possible inequities with respect to employee ownership schemes (some companies will offer very good schemes and other nothing) the board of directors of the SPA has made recommendations regarding concessions to be given to employees.

- the discount on the price may be increased to as much as 12 months' salary and should be granted to all employees.

- the volume of discount granted to employees must not exceed 10% of company's founding capital.

- when totalling up concessions provided, all discounts and payments by instalment, as well as concessions obtained by means of employees shares and property bond should be taken into consideration.

- The employees' shares should be valued at 50% of their face value because of the limited possibility of trading them. In order to encourage the participation of employees in the privatization process an opportunity to represent their interests must be provided (SPA2, 1992: 78).

APPENDIX C

Compensation Program

On June 26th, 1991 the Hungarian parliament approved the final version of the Compensation voucher program, a law designed to compensate original property owners for losses incurred in the nationalization of the economy during the 1950s (Tozsde Kurir, 17/10/91:13). The purpose of this legislation was not only to provide compensation for losses but also to increase investor confidence which had been marred due to the questions of ambiguous ownership rights. Through this legislation the government clearly outlined the rights of former owners, or their rightful heirs, with respect to nationalized property.

[with the compensation program] the privatization process will no longer be held hostage to unresolved questions pertaining to ownership (BEE, 27/01/92: 41).

Due to the many changes of ownership and use of properties the actual restitution of such properties would be impossible. Furthermore, the financial position of the government would make straight financial restitution also impossible (HMR, 6/91:11). What the law provides as a partial restitution for eligible acts of nationalization to be given to eligible claimants in the form of compensation vouchers.

Eligible claimants include essentially any foreign or domestic citizen who incurred losses. What is not eligible are "legal entities" since the majority of such entities no longer exist and those that do such as local governments etc. will be compensated under separate legislation. Specifically, all Hungarian citizens are eligible as well as foreign citizens who held Hungarian citizenship at the time of the loss, foreign citizens who had their Hungarian citizenship taken away before the loss, and foreign citizens who were

residents of Hungary on Dec. 31st, 1990 while maintaining their original citizenship. Furthermore, children and surviving spouses are eligible however children can only claim their portion of the compensation. That is to say that if the original claimant had two children but only one lives now, that child is only entitled to 50% of the original claim.

The amount of claims is a calculation of the 'average present value' of the property lost, the exact calculation of which is done according to an appendix of the legislation. As mentioned above such claims are payable in the form of vouchers which are legal tender similar to a Bearer Bond, may be sold or transferred to any individual or legal entity without restrictions, and may be used to purchase re-privatized properties (HMR, 6/91:11).

Specifically the voucher can be used to purchase stocks or shares in privatized businesses; agricultural land offered at public auctions; and residential properties³. Additionally they can be used at face value as equity when applying for credit under the small business or privatization credit programs, and it is accepted as security for establishing annuities for the claimant.

The Law does not intend to restore the original assets, however in some cases the voucher allows for the right of first refusal to the claimant on the given property and it also outlines special provisions for such specific areas as agriculture and it allows the SPA to temporarily suspend acceptance of vouchers should the coordination of their use become out of control.

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³ Restrictions apply to the purchase of residential property that the purchaser can not use more vouchers than he/she is entitled as a claimant.

APPENDIX D

Privatization Methods

Despite the initial controversy and scandal surrounding 'spontaneous privatization', such Company initiated (spontaneous) privatization is still the most common in Hungary and in fact its frequency has increased since the inception of the SPA controls. The current process is relatively simple with transformation and privatization being initiated by the company. State interference is generally limited to a controlling roll where the SPA acts as a representative of the state interests in negotiations surrounding the transformation and sale of the SOE. The SPA may also act as an advisor in some cases however this is not true in the majority of cases.

In the majority of the major company initiated privatization, a foreign strategic investor is involved (SPA, 1992:5). In fact in the SPAs first 18 months of operations it is estimated that over 85% of privatizations involved foreign investors. The selection of foreign partners takes place on the basis of either open or closed tenders and the main criteria for judging offers is "the opportunities the prospective venture will create regarding the asset in question and the economy as a whole" (ibid). That is to say the ability of the venture to further the goals of the state for privatization (to increase capital, improve technology, and secure long term market prospects).

The programs set up in Hungary to encourage privatization fall in to essentially four categories; the active privatization where the SPA selects firms or industries and forces privatization; the pre-privatization tailored for the small and medium size enterprises in the retail, catering, and service sectors; the investor initiated privatization

designed to allow prospective investors to approach the SPA to initiate the sale of an enterprise; and the new self-privatization which allows firms to privatize without SPA controls. The purpose of all of these programs have been to speed up the privatization process in Hungary, since company initiated has not proved as effective as predicted, and to encourage investment particularly by foreign investors. The 'active' privatization program has included major cross-industry programs as well as several industry specific programs and also establishes an advisory, financial and investment network for privatization.

The 'first' privatization program, announced September 1990, involved the privatization by international consultants of twenty of the larger and generally better performing companies. The aims of the program were "to stimulate competition by the way of privatization, to expand the capital market, to improve the efficiency and viability of the privatized companies, to foster the introduction of a large number of small investors into the market and to provide income for the state" (SPA2, 1992: 25).

The companies volunteered to be part of the program and were selected based on having: "satisfactory business performance; a positive attitude toward privatization; the option of employing a number of privatization methods; and the fact that preparations for privatization had already started" (ibid). This is a longer process than the spontaneous privatization but in return it provides both the investor and the public clearer terms for competition and a more easily observable situation.

The process was performed by international consulting firms who bid for the rights to the privatization of the participating companies. To date the results of this

program have not come as quickly as expected, however some good results are beginning to be seen.

The 'second' privatization program "was intended to articulate the organizational, financial and legal conditions of the so-called 'shell' companies, as well as the enforcement of the state's ownership interest" (ibid: 7). This was an attempt to address the state enterprises where a significant percentage of the company assets had been transferred to private limited liability companies during the early period of spontaneous privatization prior to the formation of the SPA in order to protect against any further loss of assets.

This program involved twelve companies, in the first stage. Domestic consulting organizations, professional committees, and the directed participation of the relevant ministries first examined the realistic privatization potential of the companies. The goal of this program was that the state be able to follow the process by which its property passes into the hands of limited companies and keep an eye on the extent to which further maintenance of the company would be justified and what possibilities there might be for realistic privatization (SPA2, 1992:33). The primary aim in the privatization was "to bring about sales to investors operating in the same industry" (SPA, 1992: 8), however when this was deemed to be impossible the agency recommended liquidating the remaining assets and eliminating the remaining 'shell' company. In total approximately 60-80 companies have come into this program in groups of 10-15.

The industry specific 'active' privatization programs include the wine producing sector, the construction industry, the sugar industry, and a special program to assist those

companies most directly harmed by the collapse of the CMEA which led to a dramatic decrease in Soviet-Hungarian trade, not to mention trade with other former CMEA nations. Under this last program fifteen companies were selected and examined by eight well known investment banks. The outcome being that only seven were viable for privatization with foreign investment. Of the remaining eight four were rejected for privatization and four were considered not viable for successful introduction of foreign investors (ibid: 8).

One of the primary aims of the active-privatization programs was to privatize companies after restructuring either through private placement, public or private tender, or through the sale of shares on the domestic and international stock exchanges. Many factors, not the least of which being the lack of resources at the SPA to allow for effective restructuring and the lack of experience of the stock exchange, have lead to the conclusion that these programs are not viable. The lack of success of the first privatization program lead the SPA to the conclusion that privatization of large SOEs must be done on an individual case basis (Tarkany Szucs, 1992: 12).

The Pre-privatization program governs the privatization of the retail, catering, and service industries and involves small to medium businesses which would, in a market economy, be carried out by the family or small scale entrepreneur. It is designed almost exclusively for Hungarian investors with the objective of creating a relatively large middle class, which is crucial for the functioning of a market economy¹. The process is simplified for such enterprises with the SPA having a role in only the most important

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¹ This point is emphasized in Stark 1991, when he discusses the debate regarding institutional versus natural ownership and reiterated in the second SPA document of 1992.

decisions.

It is essentially the SOE who carries out the process which involves the sale of the enterprise primarily through auctions based on recommended reserve prices determined by property valuers. It is expected to be accomplished quickly. Initial difficulties arose due to a lack of information regarding what was to be privatized and a lack of a necessary credit structure to allow for smaller domestic investors. However, this program has been quite successful to date. Auctions started April 1991 and as early as June 15th over 900 enterprises had been sold.

Investor initiated privatization was introduced in February 1991 and within its framework, offers for the purchase of state assets can be made directly to the SPA. This program is primarily designed to encourage foreign investment due to a lack of domestic purchasing power. The process is expected to be completed within 90 days of the offer to purchase (SPA2, 1992: 47). The first stage involves the SPA determining if the given asset is saleable. Subsequently the SPA invites other offers for the asset in competition with the original offer and the SPA then decides upon the best offer².

Some criticism has arisen with regards to this process with accusations that it takes too long, that it is unfair to original investor, that there are no appeals to SPA decisions, and that the arbitrariness of the decisions create great uncertainties. However it represents a good means for foreign investors seeking investments in Hungary to get into the privatization process.

This program also governs management and employee buy-outs. One important

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² For a good straight forward description of the process in investor oriented privatization see "About Privatization" in Hungarian Market Report, (4) 1991, pg 45-49.

note is that if a given enterprise is already part of another program the SPA will not accept offers for the purchase of that enterprise. A given enterprise can only be privatized through one privatization program or method.

The 'self' privatization program is new and allows for the transformation and sale of companies without the direct involvement of the state. The administration of this program was allocated to a separated legal entity (PRIMAN) set up by the SPA to circumvent restrictions on its actions which stem from its status as a government Agency. Under this program, the SPA will accept any privatization on the condition that the given SOE is on the approved list for the program and the privatization takes place through the employment of an SPA approved independent consulting and property evaluating company. If it is found that the privatization "violates any regulations or contradicts the interests of the Hungarian economy" (SPA,1992:10), the SPA will impose sanctions against the consulting company banning it from any further work in privatization. The first stages of this program started at the end of 1991 involving 84 consulting companies and approximately 400 SOEs. The second state commenced in the summer of 1992 and will involve approximately 400 SOEs and 130 consulting firms. For now this mode of privatization has been limited to small and medium size companies of less than 300 employees and 300 million forints annual turnover, but its success to date has lead people in the SPA to predict that it may become the primary mode for privatization in Hungary (Interview at PRIMAN).

Questions have been raised regarding whether this self privatization marks a return to the uncontrolled, or unregulated, spontaneous privatization of the late 1980s.

This is not likely since there is now a clear system in place and potential sanctions against the registered consulting companies would deter any wrong doings.

APPENDIX E

FOREIGN DIRECT INVESTMENT LEGISLATION

Hungary first allowed FDI in the form of joint ventures with foreign participation in 1972. However due to the restrictive nature of this legislation very few foreign JVs were formed in Hungary before 1987. In fact the total number of Jvs domiciled in all of Eastern Europe at the end of 1987 were only 166. Of that total, however 110 were in Hungary. Nearly half of the 1987 total were formed in 1987.

Joint Venture or Foreign Investment legislation⁴

1972 Legislation

The goals of the 1972 joint venture policy were outlined as follows:

"to increase the technical and economic standard...the development of commercial relations and to bring profit. Additional secondary considerations included the better catering for home markets and a higher level of performance of deliveries under foreign contracts ...(and to promote) Hungary's participation in international trade" (Toldy-Osz, 1974:15)

According to the 1972 decree, joint companies were allowed to be established as joint-stock companies or limited-liability companies under Hungarian law. All EWJVs had to be registered and approved by the Ministry of Finance. These joint companies were to function as 'development enterprises' engaged in research and development, commercial, or service activities. The decree excluded JVs from direct participation in

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⁴ The following represents a summary of Hungarian legislation as outlined in the United Nations publication East-West Joint Ventures, 1986. Interpretation of the legislation by Zoubek (1974), Brown (1988), Toldy-Osz (1974), McMillan (1974), Bunge (1990), OECD (1991) and various issues of Business Eastern Europe were also consulted.

production activities, unless approval from the Hungarian Council of Ministers were obtained. However, JVs could own industrial assets such as machinery or patents and were expected to enter into contracts with Hungarian producing enterprises. The assumption was that the joint venture would act as a research and development department where technological development would be transferred to the local partner's production facilities which were held separately from the joint venture.

Foreign ownership was limited to 49%, with no exceptions and EWJVs in Hungary were to operate as an Hungarian company and were subject to all Hungarian statutory rules. This meant that mere approval of a JV was not sufficient to start operations. The JV had to apply for and obtain all permits which Hungarian companies were required to obtain before commencing operations.

EWJVs were given preferential tax treatment. Regular Hungarian companies were taxed up to 70% whereas taxes for JVs were set at 40% on profits up until 20% of the capital of the Association and 60% profits exceeding this 20%, with special tax breaks if profits were reinvested to increase the assets the association.

Furthermore the foreign partner could request a guarantee from the National Bank of Hungary to cover damages resulting from eventual acts of the Hungarian government or the Hungarian partner. The joint company was required to set aside 10% of assets to cover potential losses and 15% of wages and salaries. Employees of foreign nationality were allowed to repatriate 50% of any kind of their incomes, paid by the association.

To control the balance of payments and hard currency balances, Hungarian state

was in full control of operations influencing the balance of payments. In essence no activities were allowed to create a hard currency deficit. All foreign currency operations must be carried out in accordance with the regulations applicable to Hungarian domestic enterprises.

1978 Amendments

In 1978 the legislation was amended to the establishment of JVs directly involved in production activities. Furthermore, the restriction of only up to 49% foreign ownership was relaxed for ventures in financial and service sectors and the tax rate was relaxed to a straight 40% of profits.

1982 Amendments

In 1982 Hungary enacted further legislation to promote greater interest in EWJVs and to promote exports. Custom free zones were set up inside the country which allowed JVs to be considered 'foreign legal entities'. This meant that the JV would be exempt from many restrictions governing Hungarian enterprises. It would allow for imports and exports without paying customs duty unless the products were sold in Hungary. Furthermore, these JVs were allowed to hold their assets in hard currency and to have autonomous foreign trade rights.

The 49% foreign ownership restriction was amended for banking and service ventures and the strict application of this restriction for other sectors was alleviated slightly. In essence this percentage foreign ownership restriction was not removed but was to be less of an obstacle.

Further easing took place in the area of hard currency requirements. Hungarian

organizations proposing to enter into cooperation with western companies were no longer required to prove in advance that hard-currency earning from the deal would equal or exceed hard currency expenditure.

1986 Amendments

In 1986 more tax incentives were enacted to promote EWJVs and the long bureaucratic authorization procedures were streamlined. The general tax rate of 40% remained however tax breaks were allowed in certain circumstances where the JV contributes to the economic goals of the Hungarian government. Furthermore, agreements were made with most developed nations to attempt to avoid double taxation when profits are repatriated. In terms of streamlining the authorization process, the Hungarian partner was permitted to engage in independent negotiations with potential western partners without consulting the Ministry of Finance until substantial negotiations had commenced. Furthermore, a time limit of 60 days was placed on the Ministry for a decision regarding approval of a memorandum of association.

1988 Act on Foreign Investment

Effective January 1st 1989 legislation on Non-Resident Investment granted western firms guaranteed state indemnification and compensation in the event of nationalization or expropriation. It further allowed foreign shareholders to participate in the formation of other businesses and for 100% foreign ownership of any forms of companies as outlined in the 1988 Companies Act. Further tax incentives to make JVs more attractive are granted and the legislation further allows and permits the

repatriation, in convertible currency, of capital and profits. It is interesting to note that this legislation, as well as the Company Act, was drafted and came about under the old regime prior to the formation of a new democratic government. The goals of the legislation are outlined as:

- the further development of a market-economy in Hungary in which private initiative plays an important role;
- the creation of greater opportunities for competitive forces in fields such as manufacturing, trade, and services, to operate; and
- the lifting of bureaucratic obstacles

(Hung. Econ.19/1991: 12)

1990 Amendment

The 1990 amendment which came into force January 1st, 1991 decreases requirements for formal authorization and lifts many bureaucratic provisions. It also provides amendments to tax allowances which resulted from high inflation and changing economic conditions.

Company Act 1988

1988 brought the passing of the *Company Act*. The law sets out six legal forms of company which may be established. These are: unlimited partnerships in which the partners are joint and severally liable; deposit or limited partnerships in which at least one partner is limited in its liability; business unions; joint enterprises in which all members are liable jointly as collateral guarantors in the proportion of their contribution to the company; limited liability company; and company limited by shares. The first two options, as partnerships do not involve the creation of a separate legal entity, while the other four do.

The law also sets out the rights and obligations of companies as legal entities. Accordingly a company may acquire property, enter into contracts, may sue and be sued, and enter into business associations with other domestic and foreign organizations. Finally the law eliminates any discriminations between Hungarian and foreign entities. This act set the stage for allowing both the formation of new wholly owned private companies, and for the privatization of existing companies⁵.

Bankruptcy Act 1991

The Act outlines two alternative avenues for defaulting debtors. The first option, Reorganization, is similar to the US concept known as Chapter 11 and allows the debtor to achieve a settlement with creditors to continue operations. The second option is liquidation. Under the Act the Debtor may be forced to file for bankruptcy if any debt is more than 90 days in default. After filing the debtor is entitled to a 90 day moratorium on monetary claims other than wages. If the debtor opts for restructuring he has 60 days after filing to work out a debt restructuring plan which must be approved by all creditors. If that plan is approved the bankruptcy procedure is announced to be concluded within 15 days after that. If a reorganization option is not completed within 90 days of filing the company automatically goes into liquidation.

Competition Act 1990

Governs the prohibition of unfair market practices and misleading advertising or unfair

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⁵ Specific discussion of how this allowed for privatization is found in chapter IV.

acquisition and use of business secrets. The law deals with the traditional areas of anti-monopoly enforcement, including horizontal and vertical agreements among firms, abuse by a single firm of a dominant position, and merger control. It sets out a specialized anti-monopoly office, *The Office of Economic Competition* to enforce these provisions.

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