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Determining Factors of Environment of FDIs in CEE

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Determining Factors of Environment of FDIs in CEE

Tibor Palánkai*

1. General characteristics of FDI in CEE

In Hungary, the first joint venture legislation was passed in 1972. In Poland, after 1976, the "Polonia Law" was introduced, which allowed foreigners of Polish origin to set up (mainly) small companies (about 600 up to mid-1980s). After 1982, foreign banks have been let into Poland in the form of joint stock companies. Joint ventures were also allowed in Yugoslavia, Rumania, Bulgaria China and Vietnam.
Most of the legislations, however, were fairly restrictive till the mid-1980s. The philosophy of legislations was that joint ventures with Western firms were allowed, but under strict limitations. They were based on the assumption (mistaken) that Western firms are eager to catch business opportunities in the East, and they will compete for these opportunities even under unfavourable conditions. As a result, the number of joint ventures and the volume of investments remained very limited. In Hungary, between 1972 and 1984, only 30 joint ventures with about $30 million were set up.
The real liberalizations came only after 1986. In Hungary and Poland, *more "competitive" and attractive laws* were passed in 1986 and in USSR in 1987. It was realised, that just permitting foreign investors to come, is not enough, but in the given international climate, they have rather to be attracted. In Hungary, the policy of full integration of joint ventures into the economy was chosen, in order to further ferment market reforms. In some other countries (SU), the foreign companies had to be separated ("special zones"), mainly because they could not be integrated into the planning system. In 1989, the foreign companies' treatment was put on equal basis with the Hungarian ones ("national treatment"), and their operation was fully liberalised. After 1990-91, all of the other countries passed similarly liberal laws.

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In terms of *direct capital investments, the CEE countries opened their economies by early 1990s*. The regulations of former central planning had been abolished, and the institutional and legal frameworks for FDIs were not only created, but several measures (tax preferences, setting up tariff free zones, freeing profit repatriation, etc.) were taken to offer favourable investment opportunities for foreign companies. CEE actively entered into the global competition in order to attract foreign investors. Full capital market liberalization, however, was implemented only from early 2000s, related to EU adhesions. According to an OECD study, examining the restrictions on foreign personnel and operational freedom, screening requirements, and limits on foreign ownership, the CE members (Hungary, Czech Republic and Poland) of the organization, are placed into group of "least restrictive" countries. (OECD Economic Outlook, No. 73. 2003.) Due to new measures of attracting FDIs, Slovakia also belongs to this group.
In terms of *ability of attraction of foreign capital the great differences* among the countries of the region remained. The former reform countries (Hungary and Poland) were clearly in advantage. In several countries, the poor infrastructures, particularly in communication and transport, were deterring factors for the foreign investors. The weakness of internal capital markets was, and in many respects is still broadly felt as an obstacle for foreign investments. Particularly at the beginning, the high interest rates (15-20% higher than in Western Europe) increased the capital costs, and made it impossible or difficult to finance the enterprises from the local capital markets. The legal-bureaucratic regulations were not always totally eliminated, and the frequent changes in laws (uncertainty and unreliability) had very negative effects. Sometimes, serious problems arose concerning the interpretations of legal regulations. In many countries, the social-political instabilities (discussions about selling out the country, hostility of nationalist forces against foreigners, and not to speak about civil wars) were also deterring foreign investors.
The joint ventures and foreign investments play strategic role in integration of CEE into the global world economy. Therefore, their development, which have been unfolding since the end of 1980s, tells lot about their transformation and integration.

Tab. 1 – Annual FDI inflow in Central Eastern European countries (million USD)

	1991	1992	1993	1994	1995	1998	1999	2000	2001	2002	Stock in 2002
Albania	:	20	58	53	70	45	41	143	207	213	988
Bulgaria	56	42	40	105	90	537	819	1002	813	479	3889
Romania	40	77	94	341	419	2031	1041	1025	1157	1106	8786
Slovakia	-	-	166	255	300	684	390	1925	1579	4012	10225
Slovenia	-	111	113	117	150	216	107	136	503	1865	5074
Croatia	-	:	120	117	114	932	1467	1089	1561	981	6029
Ukraine	-	200	200	159	267	743	496	595	792	693	5355
Czech R.	-	-	654	878	2568	3700	6310	4984	5639	9319	38450
Poland	291	678	1715	1875	3659	6365	7270	9341	5713	4119	45150
Hungary	1462	1479	2350	1144	4519	2037	1977	1646	2440	854	24416
Total	2637	4681	7086	6304	14811	22479	25145	26373	25015	28709	187868

Source: UNCTAD.

Main characteristics of joint venture developments and foreign investments in CEE:

1. Till the end of the 1980s, the interest of foreign capital was limited toward the region, and *acceleration started only after 1989*. In Hungary, up to 1988 only 50 joint ventures had been set up, with about $250 million capital. The big blue chip investors came to Hungary already in 1989-90. Foreign investments in CEE grew from $2,3 billion to $56billion between 1990 and 1996. Between 1989 and 1996, in Poland about $12bn, in Czech Republic $7bn have been invested. After mid-1990s, as the consolidation of CEE economies following the "transformation recessions" progressed, the FDIs further increased. By 2002, they almost reached $190bn, which meant more than three times growth in 4 years. The large transnationals seek presence in the region. From the 50 largest industrial companies 35 have already invested in Hungary. The 100 leading transnational companies of the world are represented in CEE in some forms.
The region offered attractive business possibilities, which largely explains the rapid increase of investments. According some calculations, the average rate of return on FDIs was around 11-13% in Hungary in the last 5 years (it was nearly same in Czech republic), while it was only 8% in the EU. (Világgazdaság, November 30 2001)

2. The CEE *attracted growing interest for investment* compared with other regions of global economy. In 1992, from the $1900bn global FDIs only about $8bn (with former SU about 12bn) (0,4% - 0,6%) came to the CEE region (about 80% went to OECD) and they were far behind some of the NICs. Some big investor countries, like Japan, were still mostly uninterested and reluctant to come. After 2000, due to world economic slow down, there was a drastic fall back in global foreign direct investments. The invested volume of capital shrank from $1.364bn in 2000, to $580bn in 2002, while the inflow to CEE remained on the same level (about $26-28bn) in the same period (5% of all). (Economist Intelligence Unit. 2003) The flow of FDIs into the more advanced candidate countries was stronger then one can expect from the actual level of income, market size or proximity. (Brenton and di Mauro, 1999) Between 2001 and 2002 Slovakia (from $1.5bn to $3.5bn) and Croatia (from $0.5bn to $1bn) have managed to increase FDIs in their countries. In 2002, the investments fell in Hungary and Slovenia, and the change of the trend might be function of recovery, but continued to grow to other countries (Slovakia, Romania, Serbia and Monte Negro).
3. The capital invested in the region has played an *important role in rapid modernisation and catching up*. According to the Institute for International Economics in Washington DC., the foreign capital, which would be needed to raise the amount of productive capital per worker in CEE and former SU to that of the West within ten years, would be about $1.5 trillion a year. The most favourable assumption is $90 and the "best guess" is $55 billion a year. (The Economist, July 6, 1991.) So far only half of that has been invested, even in the best years. However, there is a clear correlation between the invested foreign capital and the competitiveness of the countries of the region.

4. The role of foreign companies in the national economies is rapidly approaching the *proportions characteristic of (small) Western countries* (25-40% in GDP) in most of the countries of the region. Some of the countries (Czech Republic, Hungary, Poland) reached remarkable level of integration with foreign companies, and others are catching up rapidly. Between 1990 and 2002, the share of transnational companies in the GDP of CEEcs increased from 2% to 32%, which is comparable with the emerging developing countries (South-East Asia, China or Latin-America). (Revue Elargissement, Dossie No 35 – July 2003.)

Tab. 2 – Share of multinational companies in CEE economies

In 1999

	Equity Capital	Employment	Investment	Sales	Export Sales
Czech Republic	41.8	26.9	52.7	42.4	60.5
Hungary	72.9*	46.5	82.7	73.0	88.8
Poland	50.5	29.4	63.1	49.0	59.8

Slovenia	21.8	13.0	22.3	23.3	30.3

WIIV data www.wsr.ac.at

According to 1998 OECD data, the weight of transnationals in Hungarian industrial production was 70%, which was only a little behind of 72% of Ireland, leading the list. As results of privatisations, Czech Republic and Poland may have approached this level.

5. Until recently, *Central Europe* (Hungary, the Czech Republic and Poland) has been the *most favoured direction of investments.* At end of 2000, these three countries have absorbed nearly three quarter of all foreign direct investments coming to the region. Although their comparative wage levels were higher than many of other countries, these countries were favoured because of their more advanced legislation and banking system, and relatively developed infrastructure. At around the Millennium, there is a rapidly growing interest toward Slovakia, Slovenia, and Baltic countries, those, which also join the EU from 2004. By 2002, in terms of stock of per capita FDIs, Slovenia overtook Hungary, and Estonia and Slovakia was catching up rapidly (Czech Republic: 3603, Slovenia: 2754, Hungary: 2659, Estonia: 2647, Slovakia: 1859 and Poland: 1191 dollar). (WIIW. Data). Some of the troubled regions have attracted only limited interest so far (Southern Europe or some former Soviet republics). In 2003, the fall back of foreign investments in Hungary was due partly to European recession, but also to deterioration of competitiveness of the country (high wage increases, failure of promised cutting of taxes, drastic increase of budget deficit, etc.).

6. The *cost advantages* were concentrated mostly *on wages of skilled workers.* Early 1990s, the average labour costs per hour were about DM 4 in the Szentgotthard (Hungary) factory of GM, one tenth of West German levels. When the Volkswagen' subsidiary Audi began to construct a new major plant in Győr, in Hungary, (instead of Saxonia), in February 1993, the sole reason for the choice was cheap labour. (The European, 4-7 February, 1993.) The average monthly gross wages in manufacturing and services (in 1999) in Denmark were €3.047, in Germany € 2.674, in France €2.127, while in Slovenia they were at €825, in Poland at €415, in Czech Republic at €359, in Hungary at €318, in Romania at €136 and in Bulgaria at €100. (Eurostat.) Of course, while they greatly motivate investors, other factors are equally taken into account. Often the other local input costs are high (rents, or communication costs) and the partners or subcontractors are still unreliable in terms of quality or delivery.

7. So far, the flows have remained *mostly "one way" character*. Investments in the opposite directions have remained marginal, although in some countries started to accelerate. The Hungarian capital export started to grow from 1997 (€400million

was invested abroad), and by the end of 2002, it reached €2.8bn. According to 2000 data, the Hungarian per capita direct investment abroad was €201, while it was €77 in case of Czech Republic, and €39 in case of Poland. The reason of leading position of Hungary was due to early liberalization of capital export. Most of the capital was invested in the neighbouring countries. The Hungarian capital abroad is still only around 10% of capital invested in the country. Some member countries, which have similar level of development, like Ireland, Portugal or Spain, recently, have become net capital importers. On the long run, one can assume that this trend can also apply to the integration of CEE countries.

8. The capital flows were greatly *influenced by privatisations*, which took substantial proportions in the region. Privatisation by foreigners concentrated to certain sectors, namely sectors of state monopolies (tobacco, alcohol or energy), food processing, banks, and public utilities (telecommunication, electricity and gas supply etc.). In manufacturing, where for structural reasons, the assets of many state firms rapidly devaluated, the foreign companies preferred rather the "green field" investments. Therefore, in some periods, the proportion between privatisation and green field investments was function of big waves of privatisation. In Hungary, already between March of 1990 and October of 1993, more than 60% in the whole was green field investment, and only 40% went to privatisation. But, due to large-scale privatisation of the huge energy and telecommunication companies, in 1995, from the more than $4bn only $1,2bn fell on direct investment. Normally, the annual average of investments was about $1.5-2bn. The similar privatisation of these sectors in the other countries, brought waves of substantial increase in volume of invested capital, and divergence among the country. As possibilities of privatisation are exhausted, flows may be more balanced, and more emphasis falls on direct development of new capacities (green field investments).

9. During the nineties Hungary was one of the most successful countries in the world with respect to FDI inflow. The degree of success is shown in the fact that per capita FDI inflow for this decade was higher in Hungary than any of its main competitors in the region. We have to take into consideration that FDI data presented by international organizations (UNCTAD, IMF) based on data gained from relevant national banks, have several shortcomings and make regional comparison difficult. An attempt at making data comparable through filling in the gaps for countries, including Hungary, is presented bellow.

Tab. 3 – FDI inflows to CEE countries based on UNCTAD data (in percentages)

	1990	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Czech Rep.	---	---	---	11,1	19,4	22,8	16,2	14,2	27,5	38,6	23,9
Czechoslo-vakia	34,1	25,5	32,0	---	---	---	---	---	---	---	---
Estonia	---	---	2,4	3,2	4,8	1,8	1,7	2,9	4,3	1,9	2,1

Hungary	**51,2**	**62,1**	**42,7**	**45,9**	**25,6**	**39,6**	**25,9**	**23,7**	**15,1**	**11,9**	**10,2**
Poland	14,7	12,4	19,7	33,7	41,9	32,5	51,2	53,5	47,2	44,4	52,1
Slovakia	---	---	---	3,9	5,5	1,7	2,9	2,2	4,7	2,2	10,8
Slovenia	---	---	3,2	2,2	2,8	1,6	2,1	3,5	1,2	1,0	0,9
Total	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0

Source: UNCTAD (1996), (2001) own data

There was a tendency of underestimation of FDI data into CEE, especially to Hungary. We have to make a distinction among three major components of FDI inflows: equity capital, reinvested earnings, and intra-company loans or debt or other capital. For example, data on FDI in Hungary did not include apport and reinvested earnings, while other candidate CEE's FDI data included them, or FDI data for Slovenia did not include intra-company loans or debt. When we make all the corrections in FDI data the regional position of CEE countries might change.
Based on original widely used data, Hungary's ability to attract FDI has deteriorated sharply, while the Czech Republic and Poland have seen a spectacular improvement in their own performance in recent years. Has Hungary really lost its former leading position in FDI inflow? To answer this question we have to distinguish between 2 main periods of FDI promotion in Hungary. The corrected data (by reinvested earnings for Hungary, intra-company loans/debt for Slovenia) do not shift too much the order of the country list within the CEE region. From the late 80s until 1995 Hungary took an absolute leading position every year regarding FDI inflows and its accumulated FDI stock was higher by 62% than that of the Czech Republic and 52% higher than Poland's FDI stock in 1995.
From 1996 Poland took over this leading position, which can be partially explained by its size. Poland was able to double FDI inflow for example between 1997-1999. Hungary was still in the second place in 1998, based on FDI data adjusted for reinvested earnings, but from 1999 the Czech Republic has moved up to the second place, by increasing FDI inflow four times and pushing back Hungary to the third place.

Tab. 4 – Corrected FDI stocks of the six most developed CEE countries

	FDI stocks (IMF) (in million $)	**Corrections (1996-2000) (in million $)**	**Corrected FDI stocks (in million $)**	**Corrected FDI/capita (USA $)**
Czech Republic	21 095	-	22 545	2 199,5
Estonia	2 645	-	2 645	1 836,6
Poland	33 603	-	33 603	868,7
Hungary	19 720	+ 8 270	27 990	2 799,0
Slovakia	4 504	-	4 504	832,5
Slovenia	2 809	-	2 809	1 411,3

Source: IMF balance of payments statistics

The loss of Hungary's former leading position was partly due to the Czech stabi-

lization and modernization policies putting FDI at the focal point of the restructuring of the economy. They worked out new generations of comprehensive and EU-compatible investment promotion programs (Act on Investment Incentives, 1998, 2000, 2002) providing much more benefits for the investors than ever before. The Czech investment promotion program became not just competitive, more comprehensible and transparent but also much more efficient.

2. The development of the Hungarian investment promotion system

Hungary has a small open economy with a relatively small market, where the per capita GDP is about half of the EU average. The openness and dependence on the EU has increased after the transformation, as about 75% of its exports and 60% of its imports now come from this region. The economic transformation process in Hungary during the late 80s- early 90s lasted perhaps longer than it was expected, still it was the quickest in the CEE region. FDIs palyed a major role in the process.

We can make a clear distinction between two different periods of the Hungarian investment promotion system: the *first stage* covers the period from the late 80s until the mid-90s, and the *second stage* covers the period starting from 1996 until now.

2.1. Initial stage of the Hungarian investment promotion

The first step in the transition was the liberalization of economic activities, foreign trade, price and foreign investment policies. Hungary underwent a rather deep transitional recession period during 1989-93. In these years, the GDP growth was negative, at its deepest level of recession, Hungarian GDP decreased by about 11% in 1991. The country experienced a constant trade-, current account and budget deficit during the 90s, while inflation was over 10% all the time (peaked in 1991 by 35%, in 1995 by 28%).

Parallel with the liberalization of economic activities, one of the most generous legal frameworks in CEE was developed for foreign investors in Hungary from 1988. Foreign capital inflow played a crucial role in shaping the national accounts. On the company level, a massive wave of market exits in the form of formal bankruptcy, liquidation and downsizing played an important role. The Hungarian bankruptcy practice was exceptionally harsh in 1992/93, as all debtors with obligations past due by more than 90 days were legally forced to declare bankruptcy. Massive downsizing of former company links had to be replaced, in many cases, with new foreign company contracts.

This first period of the transition process provided a lot of opportunities for foreign investors. Hungarian privatization policy favored sales to foreign strategic investors. Consequently, FDI was mostly done through either privatization or establishment of joint ventures. Some greenfield investments started during this period, but they were a less typical form of FDI inflow to Hungary. Privatization primarily developed along existing business links, speeding up the process and making matchmaking initiatives unnecessary in a lot of cases.
Parallel with the trade and economic liberalization a generous legal framework was created for foreign investors. Foreign capital inflow was promoted by allowances of:

- Corporate income tax,
- VAT, import duties on capital goods and spare parts,
- Establishment of duty-free zones, etc.

This period was characterized by political-, macro-, and microeconomic risks of FDI, indebtedness, capital shortage and serious structural problems of the national economy, which created internally strong pressures for acquiring foreign capital resources, while externally the growing globalization and increasing investment incentives provided by different countries had to be counterbalanced. The national risks, the high budget deficits, the underdeveloped institutional system and to cope with global competition for FDI, all put the Hungarian foreign investment promotion policies into a difficult situation.
As a consequence, until the mid-90s the major characteristics of the Hungarian investment climate were the following:

a.) There were *fiscal incentives* (tax reduction, tax holiday, exemption from import duties, development of duty-free zones, etc.) at the center of the investment incentive system.

b.) FDI incentives adopted by Hungary were *typical of underdeveloped,* poor countries. For attracting more capital the government sacrificed what they needed most: future income from taxes, duties and VAT.

c.) It was an important part of the attraction of capital that foreign investors could participate in the Hungarian *privatization* process from the very beginning. Besides favorable selling prices, in a few cases the initially protected, oligopolistic submarkets provided additional incentives for foreign entry (which was soon abolished with the continuous liberalization of imports).

d.) The government tried to gain company references in the global FDI incentives war, by providing *individual deals* or substantial advantages for major TNCs, like GM, GE, Ford and Suzuki. All of them gained tax holidays for

10 years, 3 green field investors established duty-free zones gaining exemption from import duties and VAT. There were further benefits like tax exemption for 5 years and 60% reduction for the following 5 years. These allowances were provided individually for 6 companies by the Boross-government and for 18 companies by the Horn-government, until the end of 1994.

e.) The role of *financial incentives for FDI was limited,* and in specific cases subsidies were provided through individual bargaining processes instead of on a normative basis.

f.) The Hungarian investment promotion system in its initial stage was *lacking transparency, the normative and regional approaches.* A sectoral-oriented approach characterized the structure of ministries and the rest of the institutional system. And because of the general depression of the entire economy in the early 90s, it was impossible to distinguish between different regions. Finally, there were no budgetary resources for subsidizing a few underdeveloped regions and making them more attractive for foreign investors. That has lead to great regional concentration (Western Hungary and Budapest) of FDIs in the country.

2.2. The second stage of the investment promotion system

From the mid-90s both the internal and external investment incentives have changed significantly in Hungary. The macroeconomic situation started to stabilize: after 1997 the country took a sustainable growth path (with 4-5% GDP growth per year), with a relative decrease of current account and budgetary deficits. After the transition and stabilization period, the institutional and regulatory systems in compliance with market economic requirements were established.
FDI required massive investments in new tangible assets. The modernization or establishment of facilities was carried out mostly between 1993-1997. The import needs of investments increased machinery and spare parts imports in the first stage, and deteriorated trade balance, since exports from the new facilities started to grow only after the completion of the investment projects. Exports started to increase at an astonishing pace after 1996.
Taking the export level of 1990 as the base year, exports have increased by 143% in 1997, 175% in 1998, 203% in 1999, and 247% in 2000. The export intensity of foreign firms was 80% higher than Hungarian companies'. The major drivers of export growth were large foreign owned companies located in industrial free trade zones. Currently, companies with a foreign majority ownership produce 70% of total Hungarian exports and 71% of imports.
The productivity of foreign firms was also higher than the Hungarian average, but according to some researchers, their gross profits were lower and they produced

negative net profits until 1994. The productivity gap between domestic and foreign firms started to widen in 1995 and continued to do so later on. By 2000, they contributed 43% of the gross value added produced by only 24% of the total employees. The productivity gap was accompanied by a growing profitability gap too, starting from 1996.

The inherent bases for superior productivity and profitability of foreign firms are laid on their labor productivity. Foreign firms due to the favorable tax conditions started to allocate some of their global profits to Hungary, as well. From 1997, the growing majority of foreign investment was not new equity investments, but about 63% of them were reinvested earnings and to a less extent intra-firm loans. Partly because of the spillover effects and some stimulating effect of FDI activities, the widening of the productivity and profitability gap started to decelerate by the late 1990s.

Another potential way of the spillover effect is the transfer of knowledge and technology and R&D activities. Statistical data indicate a steep decline in R&D spending during the 1990s in Hungary. Both governmental and industrial sponsorship declined drastically. The overall level of R&D expenditure was only 0,5% of GDP in 1998, compared to 2,3% in 1988.

At the beginning of the privatization process there was a fear that the new integration of CEE firms required a complete elimination of R&D activities, and they would be carried out at corporate headquarters and not at local affiliates. Some empirical evidence already proved that this opinion was not fully justified. There was a reduction but also a change in the role of maintained R&D activities in CEE firms. The former widespread inefficient R&D structure was reduced and basic research was usually replaced by more product development. By 1997, foreign firms covered 45% of total industrial R&D expenditure, and their share further increased in Hungary. The R&D intensity of foreign firms was much higher than that of domestic companies.

A good number of TNCs moved their R&D activities from abroad to Hungary (like GE, Nokia, Audi, ABB, Philips, Ericsson, Siemens). The technology level of Hungarian manufacturing increased significantly as well, after the transition. Foreign companies as major engines of technology modernization, purchased more than 80% of all improved machinery and equipment in early 2000.

The picture is much more shadowed by huge regional, sectoral and income differences, which have increased even more during the 1990s and early 2000. Some large regional areas or sectors were untouched by FDI, which provided little impetus for several local firms, they remained isolated and faced to a much higher degree the danger of downsizing their traditional activities.

Unemployment levels reached 12,3% in 1993, then started to decrease slowly and stabilized by early 2000 around 5-6%, but in certain areas it remained higher than 10%. As a consequence, regional disparities became significant, on the one hand, some areas (Székesfehérvár, Budapest) became more or less saturated, and thus

facing shortages of unskilled labor, and on the other hand in large areas of the country FDI was never present.
At the same time, from the middle of the 1990s we were faced with growing external challenges. The biggest pressure came from other EU-candidate countries within the EU region. At the beginning of the past decade Hungary was the biggest foreign capital importer in the region, attracting 50-60% of the total regional FDI between 1990-93. According to UNCTAD, until the mid-90s our share was around 40% then it dropped to 24% by 1997 and further to as low as 10% by 2000. The major raison for this change was that by the mid-90s we have more or less completed the major part of the privatization process, while in other CEE countries the process just started to become more intense.
The share of new equity through privatization or green-field investments increased from 70% to 94% in Poland and from 71% to 81% in the Czech Republic, when its share dropped from 53% to 37% in Hungary between 1996-2000.
The growing majority, 63% of FDI have come from reinvested earnings in Hungary, but its importance has not been recognized either by official statistics or by investments promotional policies.
With the shrinking privatization opportunities, Hungary's ability to attract FDI has decreased sharply, while that of the Czech Republic and Poland have seen a spectacular improvement in its performance. Consequently, Hungary has lost its former leading position and moved back to the 3rd place regarding FDI attraction.
The changing internal and external environment challenged the Hungarian *investment promotion* system and its modification process started. For maintaining the continuity of the legal security the new regulations were naturally applied only for new investors and investments, but earlier gained rights were not abolished. The Hungarian government tried to fill the requirement by international organizations (e.g. EU, WTO) for harmonization of laws and undertake obligations for their modification. This was not only an external pressure but a real national interest as well.
The negative effects of the former individual FDI deals pressed the Hungarian government to make the investment incentive system more transparent and settled more on normative bases. In parallel, the consolidation of the economy and the extensive FDI inflows provided adequate bases for the elimination of individual treatments of some investors.
In summary, the second stage of the Hungarian investment promotion system between 1996-2002 was characterized by the following features:

· Elimination of individual FDI deals,

· *Normative* dealing as a principal rule,

· *Transparency,*

· The appearance of some elements of *regional approach,*

· The increasing role of *financial incentives,*

· Remained under the *dominance of fiscal incentives.*

The major elements of the FDI incentive system were the following:

a.) Fiscal Incentives:

· 10-year corporate tax relief for investors investing at least HUF 3 billion in manufacturing within regions assigned as priority development targets by the Ministry of Finance.

· 5-year corporate tax relief for investors operating in industrial areas or preferential regions.

· 5-year 50% corporate tax relief for investors investing at least HUF 1 billion and for whose sales increased by 5% of the value of its investment within the same tax year.

· Some allowance provided for investors in the hotel business if their total sales increased at least by 25% or minimum HUF 600 millions.

· 10-year corporate tax relief for investors investing at least HUF 10 billion in any areas of Hungary.

· Employing unemployed people for at least 6 months can reduce the tax base.

· Accelerated depreciation schedules were introduced in industrial zones.

· Granting tax credit based on the size of investment in business zones or an area with high (over 15%) unemployment.

· 5-year tax relief for investors in industrial zones increasing their sales at least by 1% yearly.

· Up to 6% tax relief for machinery or infrastructure investment in preferential areas.

· Direct costs of R&D can be subtracted from the tax base.

b.) *Financial Incentives*:

· Advantageous loan provided for investments in the machinery industry or infrastructure in preferential areas.

· Subsidies for R&D, environmental protection, etc. Described by the Economic Development Objectives for job-creation and training provided by Workforce Fund).

· Széchenyi-plan subsidized businesses: R&D, tourism, housing, regional development.

c.) Other Incentives:

· Institutional development of the Hungarian Investment Promotion Agency,

· Establishment of industrial parks, clusters, incubator houses, etc.

· Allowances provided by local municipalities.

From January 1, 2003 Hungary adjusted its incentive system to the EU requirements, and reached a compromise regarding the already obtained rights. The EU will not deal with the tax allowances provided before January 1, 2003, but following this date we have to consider the support intensity of the given investment. There are four groups of companies regarding support intensity:

1.) Companies which invested before January 1, 2001, are eligible to receive investment allowances up to 75% of their total investments.
2.) Companies which invested between January 1, 2001 and December 31, 2002 are entitled to receive tax relief up to 50% of their investments. (11 car manufacturers are placed in 2 further groups:)
3.) Car manufacturers which invested before 2001 are entitled to receive a tax relief up to 30% of their investments.
4.) Car manufacturers which started their investment after 2001 have a tax relief of up to 20% of their investment.

According to the agreements, companies can add investments completed before December 31, 2005 to the basis of the calculated tax allowances.
As a consequence of our accession to the EU, permission from the EU will be needed for all production within Hungarian tax-free zones. The foreign trade with the EU will be internal, thus tax-free zones will loose their importance for firms whose production are based on EU- imports for EU-exports. This will affect the 70% majority of Hungarian companies operating within the tax-free zones. After the accession, they will be obliged to pay the duties and VAT on non-EU machin-

ery imports, retroactively. From the existing 130 tax-free zones, only about 5-10 might survive and all the others will disappear.

3. Conclusions

By evaluating regulations of host countries, one can conclude: the effects of the main incentives offered by host governments on FDI location choices between countries have proven to be difficult to separate, despite decades of research. Given all the factors that can impinge on TNC decisions, it is difficult at best to isolate the effects of just one factor, such as incentives on FDI location and characteristics. The impact of these factors on investment decisions can also differ among TNCs depending on their strategy and motivation for the investment (resource seeking, market seeking, factor seeking), size, experience, whether the investment is a new one or an expansion, and the TNCs country of origin. Nevertheless, there is overwhelming evidence to suggest that incentives are a relatively minor factor in the locational decisions of TNCs relative to other locational advantages, such as market size and growth, production costs, skill levels, political and economic stability and the regulatory framework. However, the impact of incentives is not negligible: if one country offers incentives and another does not, then, all other things being equal, foreign investors could be influenced in their locational choices between countries.

With respect to different types of incentives, fiscal and financial incentives seem to rank *pari pasu* in terms of FDI preferences. Among targeted FDI incentive packages, those geared to promoting exports have proven to be the most effective.

The experience with incentive packages suggests that, to be effective, the design of incentive programs aimed at attracting FDI with specific characteristics not only involves careful targeting of those elements that are desirable, but, in addition, *policy coordination* at various levels of government is necessary to ensure that the incentives do not cause undesirable side effects.

There is often conflict between the goals that governments want to achieve, the incentives systems through which these goals can be achieved and the capacity of the institutions charged with implementing the incentives systems. At the same time, there is often a trade-off between incentives that are targeted to achieve specific policy goals and more general investment incentives. The more targeted an incentive, the greater its impact – but also the greater the chance that it leads to biases and distortions that impose economic costs.

In summary, we can conclude that attraction and "competitiveness" of foreign investment promotions systems proved to be important only in relations to the other countries of the given region. Attractive incentive systems are necessary, but not satisfactory conditions. Lack of incentives may deter investors, while good regulatory conditions may not be enough to attract investments from abroad. While these regulatory factors played important role in FDI decisions in certain cases and certain period, in general, there have been several other determining factors, which have influenced the behaviour of foreign investors much more than the competing policy measures and frameworks. Among them, the following should be stressed:

1. General economic and political situation in the country. In this respect, the progress and radical character of transformation played decisive role. The consequences of transformation crises were felt in each countries, but its depth and then the speed and the success of stabilization basically influenced the foreign investors. In this context, the leading role of the three CE countries (Czech Republic, Poland and Hungary) in receiving bulk of foreign investments during the 1990s was clear proof of that phenomenon.
2. The rapid and market-based privatisation in Hungary was one of the important factors of leading role in FDIs in the early years. Privatisation policies, particularly conditions and concepts greatly influenced the investors' decisions (coupon or market privatisations, "real" or surface privatisations, privatisation techniques and preferences etc.)
3. Inheritance of reforms was a clear advantage. This was due partly to the early transformation measures (steps toward marketisation already in second half of 1980s in Hungary), and also to the early re-orientation of relations to Western partners (Hungary and Poland).
4. Political stability of the country, and the ways of accompanying systemic changes and political transformation. In CEcs, the change to democracy was relatively smooth and rapid, while in other countries democratisation was slow and contradictory. Later countries were also lagging behind in attracting foreign capital. It was more the case, where political changes lead to serious conflicts, including civil (ethnic) war. (Balkan or Caucasus)
5. The state of the economy, particularly structural change and stabilization were also among the number one motivations. The rapid stabilization of Polish economy by a successful shock therapy created good business confidence and contributed to better investment climate. Better state of the economy (no need for shock therapy) had also positive effects (Czech Republic or Hungary), while delayed and sluggish stabilization was a deterring factor.
6. Beyond the related investment regulatory framework, particularly the direct incentives, the stability and transparency of economic regulators in general might have been more important. Working institutional and regulatory systems (deregulation, liberalization, rapid introduction of market-conform policies, like tax reforms, convertibility, trade policies) all proved to be equally important.
7. State and flexibility of factor markets (banking system, capital and labour markets, development of the stock market etc.) played also decisive role. The privatisation of the commercial bank sector, the development of financial markets and financial infrastructures influenced on a great extent the whole investment environment.
8. Role of political, social and legal security factors (internal criminalisation, corruption, radicalism of trade unions, strikes etc.) should be also stressed.

In fact, in case of several countries, on a large extent, they explain, why foreign investors stayed away from the country or the region.

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