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# *The Strategy towards Foreign Direct Investment.*

# *Comparative study on Romania and Hungary*

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## *Abstract*

The paper *The Strategy towards Foreign Direct Investment. Comparative study on Romania and Hungary* deals with the different performances of Romania and Hungary respectively in attracting foreign direct investment, with a view to identifying government policies that can positively influence the flow of foreign investment. The theoretical backbone of the paper is represented by location theory. The study was based on surveys and interviews with FDI stakeholders (business people, government officials, and analysts). The findings emphasise the role of government related factors in influencing the flow of foreign direct investment, especially maintaining a simple and stable regulatory framework, and a stable macro-economic environment. These findings run counter to much of the current business literature. In addition, in another departure from common wisdom, the study does not find support for the claimed importance for tax incentives in stimulating the flow of foreign investment. Finally, there is apparent a difference of outlook between the business community and the government agencies in charge with dealing with foreign investors, that helps explain the public policy failure.

**Keywords:**

Transnational corporations

Foreign investment

Hungary

Romania

Central Eastern Europe

# I. Introduction

The growth in the Foreign Direct Investment (FDI) is probably the most pregnant feature of what is largely perceived as the relentless advance towards the globalisation of the economy, and eventually of the society perhaps. The countries of Central and Eastern Europe (CEE) rely on the foreign direct investment (FDI) to provide them technical and business know-how, financial and physical capital, to increase the economic efficiency and to enforce political and economic discipline, thus dramatically increasing the standard of living. The conclusion that it is in the national interest to stimulate the penetration of the foreign capital was reached, sooner or later, by practically all CEE countries. However, their record in the matter is far from equally successful.

"We do not sell our country!" was the most striking slogan of the 1990 Romanian electoral campaign. Denounced by the then opposition (now government), this rhetoric has since been rejected by the successive governments. If there are any traces of this slogan left, they must be only in the mentality of the people. The new orthodoxy at Bucharest became the improvement of the country's image in order to attract foreign investment. Ten years after Romania started its transition, the bulk of capitalists eager to buy our ailing state factories is nowhere to be seen. At the end of 1996 the stock of foreign investment in Romania barely reached 2.3 billion dollars - in the second largest country of Central and Eastern Europe (after Poland) due to its 23 million inhabitants, and having a strategic geographic position (at least this is the strong belief of the Romanians). This amount was comparable with a single investment of the Korean giant Goldstar (now LG Electronics) in a Welsh plant, or, to come closer to home, to the foreign investment in the middle-sized Hungarian town of Szekesfehervar. Since 1996, things improved, but only.

This discrepancy between the (perceived) possibilities of the country and the public policy objective based on them on one hand, and the less than modest results achieved on the other hand represent the original puzzle that led to this study being put forward.

There is clearly a need for well documented research to stay at the basis of policy formulation. Unfortunately, the field of research on public policy is huge, while the resources allocated are meagre. The case for a systematic and (well advertised) research to support the increase of quality in the act of government could not be clearer.

The aim of the study is to identify the factors that bear the heaviest influence on the decision of a multinational corporation to invest in a Central Eastern European country, with a view to support the improvement of the national strategies pursued by the governments from the region in attracting a larger flow of foreign investment. In order to achieve this, the study addresses the poor result achieved by the Romanian government in this respect, by comparison with the best performing CEE country on the FDI criterion, Hungary.

The study therefore compares the Romanian and Hungarian strategy towards attracting Foreign Direct Investment (FDI) in the post 1989 period. In order to explain the variations in the flow of FDI, the study focused on the legislative and institutional framework for foreign investment, on the general macro-economic data, and on the perception of the investment climate by the foreign managers.

From a narrower academic point of view, the study attempts to advance the understanding of the investors' behaviour, and of the tools open to the political actors for influencing this behaviour. Such an understanding is for the moment very limited, at least in Romanian political and academic circles, and therefore progress in this area is needed in order to assist the formulation of public policies.

The study is structured on four chapters. The first deals with the advantages of the host country from attracting foreign investment, while the second presents briefly the theory of foreign investment, with an emphasis on location theory. The third chapter represents a case study on foreign direct investment in Romania and Hungary, presenting the legal and institutional framework for FDI, the investment climate and the dynamic of the FDI flow. Finally, the fourth chapter presents the results of the survey of investor perception. The study concludes with tentative policy recommnedations.

## II. The Attraction of Foreign Investment

The first question I decided to address in the opening of the paper is a short incurssion in why would a country, in particular a Central eastern European one, be interesting in acquiring foreign investment. The approach I have chosen is to treat foreign direct investment as a particular case of the free trade - trade in the factors of production – and to connect the matter with the larger debate over alternatives in the quest for modernisation.

Moving from general to particular, the chapter deals with the case for the freedom of trade, and then particularises to foreign direct investment, and the influence of the freedom of trade upon the location factors. Similarly, the first part of the chapter addresses issues relevant for the less developed countries in general, and then moves to discuss the particular choices opened to the Central and Eastern European nations.

The first issue discussed is the autonomous development, based on the Import Substitution Model. Conversely, a country may opt for the integration in the international markets, and this road is discussed in the second section. The next two sections address the alternatives for a Central and Eastern European country of pursuing a (CEE) regional economic integration, and of joining the European Union.

The latter is obviously the dominant strategy pursued by the policy makers of these countries.

### 2.1. Autonomous Development

The model of development based on Import Substitution Industrialisation (ISI) was popular with *dependencia* school (in spite of a general scepticism concerning the chance of a developing country to avoid dependence on the Western / Northern economies and investors) and the development economists of the 1960s. But, the practice in South American countries has not led to encouraging results. Haggard states that ISI resulted in important economic distortions (oligopolistic markets, inefficiency, high-outputs and low quality), and rent-seeking behaviour due to the important role of administrative decisions in the economic sphere. The current dominant intellectual climate is hardly favourable to such attempts to insulate from the world economy and to pursue an allegedly autarchic development (in fact, ISI resulted in chronic balance of payments deficits that prevented actual autonomy)[1]. Therefore, such an approach to economic development for CEE can be safely discarded.

### 2.2. Advantages of Integration in the International Markets

[1] Haggard, Stephan, 1990, *Pathways from the Periphery: The Politics of Growth in Newly Industrialising Countries*, Ithaca: Cornell University Press, pp. 11 - 12

The countries of CEE are entangled in a complex transformation process that involves the development of a market economy and the transition to a democratic system, for which there is little previous experience of success at the international level - with the possible exception of Chile[2]. As I mentioned in the above section, the old model of development - focused on import substitution, and state-directed development, especially of the heavy industry, with little regard for market signals through prices - proved a failure[3]. The emphasis now in CEE is on structural adjustment of the economy, especially of the manufacturing sector, to meet the demands of the markets, but this process requires also a functional financial sector[4]). The advantages offered by the international financial markets to the reform process of CEE are very important[5]. First, it is the access to funds to offset the trade deficit created by imports necessary for investment and for cushioning the drops in the standard of living of important social categories, brought about by the restructuring process. Second, it offers the possibility to acquire portfolio investment. This is a process that is going to take some more time, since for the moment not many companies in CEE countries are appealing to foreign investors, and therefore require active direct investment, rather than the portfolio, more passive one. Third, the integration of the domestic financial markets in the globalised international one will provide more stability. It will also bring the know-how and the corporate culture that are lacking in CEE. This will result in more efficient financial markets, with a better allocation of resources[6], and reduced

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[2] Roe, Alan, 1992, *Financial Sector reform in Transitional Socialist Economies*, Washington DC: The Economic Development Institute of the World Bank, p. 1

[3] ibid., p. 3

[4] ibid., p. 2

[5] Klaus, Vaclav, "Economic reform in Czechoslovakia and the Role of Foreign Assistance", in Mikdashi, Zuhayr, ed., 1993, *Financial Strategies and Public Policies. Banking, insurance and industry*, Ecole des Hautes Etudes Commerciales, Houndmills et al.: Macmillan, pp. 90 - 94

[6] Welch, John H., 1993, *Capital Markets in the Development Process. The case of Brazil*, Houndmills et al.: Macmillan, p. 3

transaction costs. It will also increase the public confidence, encouraging therefore population savings[7], mobilising the money resources from the population and increasing the confidence in the currency (if the investors can make profitable investments in assets priced in the local currency they are more likely to keep it).

### 2.3. Regional Integration

The interest for intra-regional co-operation springs from the conclusion that much of the economic collapse in the Central and Eastern Countries after 1989 had to do with the breakdown of the trade system of the CMEA (Council for Mutual Economic Assistance, the trade socialist network). The socialist economies had attained a certain (even if largely artificial) degree of integration. The countries of Central and Eastern Europe were dependent on the cheap energy provided by the Soviet Union, and much of their exports were absorbed by the large Soviet market. After 1989, the Soviet Union, and then the main successor state - the Russian Federation - cut the supply of energy at below world market prices. Moreover, the decision to abandon the trade clearance system in the fictious "convertible rubles", and the formal dissolution of CMEA have dealt a fatal blow to the East-East trade[8].

It is argued that the inability of Eastern products to be competitive on world markets and the obstacles to trade still existent in the relations with the European Union in the areas were Easterners are most competitive (agriculture, steel, textiles) - as present in

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[7] ibid.

the European Agreements -, would support the idea of developing the trade between Eastern partners. This is expected to be a useful preparation for a not so forthcoming membership in EU - given the backwardness of the Eastern economies, and the time span they will therefore require to attain a level of development compatible with membership in the club[9].

The development of free trade between the CEE countries (e.g. in the framework of the present CEFTA - Central European Free Trade Agreement) would be beneficial, at least because it would prevent the negative discrimination of East-East trade in comparison with the East-West one, that would otherwise result from the application only of the EAs. Yet, the natural flow of trade between neighbouring developing countries appears to be limited (and unable to replace trade with the developed countries), and artificial promotion of trade flows would result in overall economic distortion (as was the case in the former CMEA)[10].

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[8] Brada, Joseph C., 1994, "Regional Integration versus Integration into the World Economy: The Choices for Eastern Europe", *The World Economy*, vol. 17, no. 4, pp. 56 - 60

[9] ibid., pp. 61 - 64

[10] ibid., pp. 70 - 71

## III. Theoretical background. Theory of foreign investment revisited.

This chapter deals with the theoretical framework of foreign direct investment (FDI) on which the paper is based. The first part of the chapter is an exposition of the main trends present in the literature on explaining the foreign direct investment, and focuses on explanations based essentially on transaction and financial analysis. In the next section, a classification of foreign direct investment is proposed, with a view to the further discussion of location factors. The third part of the chapter goes deeper in the location theory, trying to understand the different factors that shape the decision of a multinational corporation to invest in a certain country. It presents the model developed by Donald J. Lecraw for investment in less developed countries, based on the framework constructed by John Dunning. Finally, the fourth section assesses the relevance of this model for the countries of Central and Eastern Europe.

### 3.1. Multinationals

The common sense definition of multinational corporations is of companies active in at least two countries[11]. Actually, in real life these corporations tend to be much larger, in many cases their activities acquiring global dimensions, and this sort of giants are the focus of political economy analysis as well as of the political debate.

[11]Caves, Richard E., 1982 (reprinted 1988), *Multinational Enterprise and Economic Analysis*, Cambridge et al.: Cambridge University Press, p. 1

*Types of multi-plant corporations*

Among the multi-plant enterprises, overall types can be distinguished. There are companies that are integrated horizontally: they acquire differently located plants that produce the same goods[12]. There are also vertically integrated multi-plant corporations, where the output of one plant represents the input for another one[13]. Typical examples are companies that specialise in the exploitation and then processing of mineral resources[14]. Finally, there are diversified corporations, that acquire plants producing a large variety of unconnected goods[15].

*Conflicting and converging theories of foreign direct investment*

These being said, the main question political economy books deal with is why these companies exist after all. Thus the theories have to explain both why companies grow big enough to acquire more than one plant (against the expectations of the perfect competition model of small atomistic companies) and why these plants are located in a different country from the country of origin of the company[16]. The basic assumption of most authors is that a company acting outside its home country, in a foreign environment, is at a disadvantage when compared with local competitors[17]. Therefore,

[12] ibid., p. 3
[13] ibid., p. 15
[14] ibid., p. 18
[15] ibid., p. 24
[16] Aliber, Robert Z., 1993, *The Multinational Paradigm*, London et al.: The MIT Press, p. 178
[17] ibid., p. 179

in order to explain the obvious fact of the existence of multinational corporations and of foreign investment, there must be some advantages that expanding as multinational must bring to the corporation, thus off-setting the disadvantage of operating on a foreign territory.

The 'product cycle theory' of Raymond Vernon states that the companies develop the new products close to their core markets, where there is a large supply of skilled labour and the proximity to clients allows the quick integration of the signals of the market. As the products become mature and the manufacturing process is standardised, the actual production location is shifted towards low skills - low costs less developed countries. [18]

Oliver Williamson considers the transaction as the basic unit of economic analysis. Therefore, he traces the development of multinational corporations to the economies on transaction costs[19]. Williamson builds on the insight of Coase, who posed the question why the limit between the administrative allocation of resources inside companies and the market allocation of resources between companies falls where it does[20]. His answer is based on the interplay between four factors: Williamson's organisational failure framework takes into account the interaction between the human bounded rationality and opportunism on one hand and the environmental complexity and uncertainty and small number conditions. These conditions result in

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[18]Vernon, Raymond, "Sovereignty at Bay: Ten Years After", in Moran, Theodore H., ed., 1985., *Multinational Corporations. The Political Economy of Foreign Direct Investment*, pp. 247 - 250

[19] Williamson, Oliver E., 1975 (reprinted 1983), *Markets and Hierarchies: Analysis and Antitrust Implications. A Study in the Economics of Internal Organization*, New York: The Free Press, p. 6

[20] ibid., pp. 3 - 4

an information impactedness that can be more efficiently dealt with by intra-company rather than market trade[21].

Richard Caves[22] proposes a somehow similar transactional theory of (horizontally integrated) multinational enterprises, theory centred upon the intangible assets. Companies acquire intangible assets (e.g. innovations, know how) that have properties of public goods (once discovered they can be put at work in other settings at no or little additional cost, without reducing its availability to the initial discoverer). The markets for intangible assets are imperfect because they suffer (more than markets in tangibles) from information impactedness, opportunism, and uncertainty. Therefore, instead of licensing its knowledge, it is more efficient for the company to acquire other production plants where the innovation can bring full profits. Similarly, opportunism and uncertainty may also determine a company to internalise the market for an intermediate product. On the other hand, new investments may be brought about by the desire to make full use of assets that are under-utilised at a certain moment - like management ability, or internally generated funds (profits not distributed to the shareholders)[23].

There may be advantages for multi-plant corporations that spring from economies of scale at the buying of raw materials, transportation or administrative costs[24].

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[21] ibid., pp. 21 - 40
[22] Caves, op. cit., pp. 3 - 8
[23] ibid., pp. 5 -7
[24] ibid., pp. 7 - 8

Diversification of investments has the role of spreading the risk associated with a single investment (or a single business)[25], and stabilise the flow of incomes due to the presence in different markets with different business cycles[26].

Another financial theory states that multinational corporations enjoy advantages in the cost of capital since they are headquartered in countries with low interest rate and invest in (and therefore compete against firms from) countries with high interest rates[27].

The 'OLI paradigm' of John Dunning puts forward a framework of analysis built around three types of factors: ownership, location, and internationalisation factors. The ownership ones are proper to the multinational corporation - e.g. the proprietary technology, access to markets, capital cost, management know-how. The location factors represent conditions prevalent in the host country where the investment takes place, and include natural resources, (low) wage rates, dimension and growth of its domestic market, exchange rate, the availability of domestic capital, the labour force, and the infrastructure. The third group of factors, the internationalisation advantages, represent the benefits springing from investing abroad in comparison with producing at home and serving the foreign market through exports or licensing - and include avoiding transaction costs and by-passing barriers to trade (tariff and non-tariff ones)[28].

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[25]ibid., pp. 25 - 26
[26]Aliber, op. cit., p.188
[27] ibid., pp. 188 - 189

Another theory is constructed on the models of the oligopolistic competition: once a company has reached a larger than the industry average growth rate it drives out its smaller competitors and increases its market share on their behalf. What results is an oligopolistic industry with only four to eight firms remaining. From now on, the firm will no longer be able to increase its market share and therefore, in order to maintain its growth rate it needs to expand into new (overseas) markets.[29]

Similarly to the set of factors that explain why the firm grows over the size envisaged by the perfect competition model, another set of factors has to explain why this growth ceases at some moment, and the corporation does not grow even larger. Aliber explains that as a corporation grows some of its costs increase in comparison with those of its competitors. He cites that fact that, with the growth of the firm, the payroll will increase in the case when the operations of the firm take place in a concentrated area, and its management expenses for the more complex organisation will also increase. Moreover, as the number of competitors is reduced there is more difficult to finance these increasing costs through an increase in the market share (that brings economies of scale).[30]

## 3.2. Types of Foreign Direct Investment

[28]Dunning, John H., 1993, *Multinational Enterprise and the Global Economy*, Wokingham: Addison Wesley Publishing, pp. 76 - 80
[29]Aliber, op. cit., pp. 187 - 188
[30]Aliber, op. cit., pp. 180 - 181

The foreign direct investment represents the acquiring by a multinational company of a production plant in another country that its country of origin. The term direct is used to differentiate this form of investment from the other kind of foreign investment: the portfolio one, that represents acquiring equity in a host country corporation. This distinction is somehow academic, as in the real life there is a high number of joint ventures, due to the interest of the foreign investor to team up with a local partner that enjoys a better knowledge of the local investment environment, and that may be better locally connected (and also placate the rejection of or hostility towards foreign investors in the name of economic nationalism). This makes it difficult sometimes to differentiate between foreign direct investment and the portfolio one. However, it could be expected in the case of fereign direct investment the foreign investor owns at least a considerable part of the respective company, that it is directly involved in management, that some transfer of technology or know how is taking place and that the brand name of the multinational is used. In contrast, the portfolio investments is passive and foot-loose, the investors usually do not get involved in management, and their leverage comes from the high liquidity of the investment that allows them to "vote with their feet". For a rigorous delimitation of foreign direct investment from the other forms of foreign investment, necessary especially for legal purposes, some authors propose the limit of 10% of equity[31].

Under the broad umbrella of foreign direct investment, one can distinguish several types of investment. A useful classification from the point of view of political economy analysis is made according to the target of the investment. The investment

[31]Bonciu, Florin, 1997, *Atragerea si Monitorizarea Investitiilor Straine Directe*, Bucuresti: Editura Stiintifica, p. 70

can be targeted primordially to the domestic market, or to the export market. Inside the latter category, a special status has the investment in the exploitation of natural resources. A special category, relatively newer, is the foreign investment directed to infrastructure projects, that requires obviously even more contact with the host government than is the case with the other forms of investment.

### 3.3. Location Theory

Building on the theory developed by John Dunning, Donald Lecraw realised a study on the host country factors that influence the flow of foreign direct investment in less developed countries[32]. Following the location factors identified by Dunning, he took into consideration

*country risk* - is based on the international ratings, and as the country risk becomes lower the flow of FDI should increase

*the level of infrastructure development* - improvements in infrastructure should also positively influence the flow of FDI

[32] Lecraw, Donald J., "Factors Influencing Foreign Direct Investment by Transnational Corporations in Host Developing Countries", in Buckley, Peter and Mark Casson, eds., 1992, *Multinational Enterprises in Less Developed Countries*: *Essays in Honour of John Dunning*, Aldershot et al.: Edward Elgar Publishing, pp. 163 - 179

*government policy towards foreign investment* - the openness of the governmental policy towards the foreign investors is considered a determinant factor on investment decisions

*taxes* - taxes are a of course a very important factor; in analysing this factor should be borne in mind that there are great variations in the taxation systems: beyond the corporate profits tax should be taken into account the tax holidays (e.g. for the first years of operation) and the tax incentives for activities in different sectors targeted by the government

*domestic capital* - the increase in the stock of the domestic capital is expected to be negatively correlated with the foreign investment: the capital becoming less scarce should determine a reduction in the returns on investment

*growth rate of the domestic market* - the increase of the domestic demand should stimulate the foreign investment

*tariffs* - variations in tariffs influence the profitability of imports, what affects the investment decisions: higher tariffs mean less imports and therefore a greater incentive to supply the market through investment (jumping over the trade barrier). However, it should be mentioned that according to some authors the dependency between tariffs and the flows of direct investment is curvilinear: the foreign investment is important when the tariffs are high, it diminishes with the reduction of the tariffs (because it becomes comparatively easier to import) but increases again when the tariffs become close to zero.[33]

*real exchange rate* - the variations of exchange rates also influence the imports, affecting the decision to supply the domestic market by investment rather that imports (an appreciation of the currency reduces the affordability of imports, encouraging investments directed at supplying the local market); on the other hand, the exchange rate has a converse relationship with the investments directed at exports: the depreciation of the currency makes the domestic factors of production and the wages relatively less expensive in other currencies, and therefore encourages the investment.

*natural resources* - the increase in the (known) base of natural resources should attract foreign investment

*domestic labour force* - the increase in the labour force should be positively related with the flow of FDI

*wage rates and the education level of the work force* - low wage rates and higher level of education of the work force should be attractive for the export - oriented multinationals and for those active in the field of natural resources (which normally end up being exported)

[33]Bliss, Cristopher and Jorge Braga de Marcedo, eds., 1990, *Unity with Diversity in the European Community: The Community's Southern Frontier*, Cambridge: Cambridge University Press, pp. 5 - 6

From a political point of view, these location factors can be grouped in three categories. Firstly, there are factors that are outside governmental control, as is the case mostly with factors like the natural resource base of the country, and the rate of growth of the labour force. Secondly, there are factors upon which the government has a certain degree of influence - the rate of growth of the domestic consumption, the country risk, the real exchange rate. Finally, some factors are entirely under the control of the government - tariffs, taxes, the openness of the country towards foreign investment. In addition, some of the factors are under immediate governmental control, while others can be influenced only over the long run[34].

Lecraw used these location factors as independent variables to predict the flows of foreign direct investment. The sample was represented by 27 developing countries with per capita income bellow $ 2200, using data for the interval 1974 - 1986[35].

The results of the regression analysis showed that all the factors had the expected sign. At the 0.90 significance level, the coefficients for infrastructure and labour force where not statistically significant. The value of the natural resources positively influenced the flow of FDI towards these area, while the changes in the real exchange rate negatively influenced the export and resources oriented FDI, without affecting the investment towards the domestic market. Tariffs had a positive influence on the investment towards the domestic market, but did not influence the other types of FDI. Tax rates influenced the export oriented and natural resources based investment, but

[34] Lecraw, op. cit., pp. 178 - 179
[35] ibid., pp. 174 - 175

not that aimed at the local market. The domestic demand influenced the market oriented investment. The wage level influenced the export oriented FDI[36].

The country risk, and the openness towards foreign investors influenced all types of foreign direct investment. Being strongly dependent on the governmental policies, they are therefore the main tools of the government in the efforts to influence the flow of FDI[37].

The domestic capital was found to mirror the evolution of the foreign direct investment, suggesting that rather than an explanatory variable, it responds to same factors as the foreign capital (spurious relationship)[38].

It was also found that the independent variables have the best explanatory power when a lag of three years is assumed between the cause (independent variable - location factor) and the effect (the variation in the flow of foreign direct investment)[39].

### 3.4. Relevance for the Central and Eastern Europe

The then communist Central and Eastern European states were not part of the study on which the model was constructed, as their statistical data were not available at the

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36 ibid., pp. 176 - 177
37 ibid.
38 ibid., p. 176
39 ibid.

time of the study. However, these countries are close to the GDP per capita class that formed the sample used in the study, and looking at the Lecraw's model it seems a convincing framework for analysing the foreign investment in any of these countries.

Yet, there are specific features in being a former communist country. The model is built (implicitly) assuming an equilibrium situation chiri suge pula: in the country there is a (stable) flow of foreign investment, then there is a change in the level of one of the location factors and the flow varies accordingly to a new (again stable) level. For countries that only in ten years have gone from an almost complete opacity to foreign investment to a relative high openness, this seems too strong an assumption. This fact is all the more obvious when we take into account that one of the assumptions of Lecraw's is that the flow of foreign direct investment reacts only to relative changes in the location factors (no matter how they are quantified). Such an assumption does not hold in the case of the former communist countries: since there used to be a very strong barrier to foreign investment - governmental policy - that blocked any such investment, once the barrier is relaxed and the countries moves to a relative political openness towards foreign investment, the flow of investment will vary from country to country function of the absolute level of the location factors present in the country.

# IV. Foreign Direct Investment in Romania and Hungary

This chapter presents the case studies of foreign direct investment in Romania and Hungary. The first sections introduce briefly the overall economic environment of the countries, focusing on the two key elements of the economic transition: macro-economic stabilisation and privatisation. Further, the next two sections deal with the legal and institutional framework for foreign investment, and the FDI dynamic respectively.

## 4.1 Economic Background

Romanian and Hungarian macro-economic indicators are presented in appendix. The Romanian economic reform has proceeded gradually (as opposed to the Polish style shock therapy) and has been dominated by the attempts at macro-stabilisation and privatisation.

*Macro-stabilisation*

In Romania, the liberalisation of prices and the elimination of subsidies for consumption opened the economic transition, in the November 1990. They proceeded in several steps (April 1991, July 1991), being largely concluded by May 1993, with the exception of some basic consumer goods (e.g. bread, meat, milk) and energy that have been under governmental control till 1997[40]. Just like the other socialist economies, Romania was characterised by a high repressed inflation. The liberalisation of prices released these pressures and the successive governments struggled with the resulting inflation. The inflation increased starting from 1990, and peaked in 1993 at 290%. There have been several stabilisation programmes, that failed successively due to the soft budgetary constrains imposed on state corporations: the large state subsidies (less so much directly, as through below inflation rate credits) and the lack of credibility of the governmental policy that determined the managers of the state companies to allow the accumulation of inter-company (bad) debt, which was bailed out by the successive governments (1992, 1993, 1995). After 1996, the restructuring policies brought forward by the new government lead to a steep decline of GDP (that is expected to stabilise in 2000), while inflation continued to stay in double digits.

Hungary did not encounter the same difficulties in maintaining a stable economic climate. Inflation has been in double digits for the period under review, what combined with balance of payments problems forced the socialist government to introduce strong measures to curb public spending. However, by comparison, Hungary maintained a stable and healthy macro-economic climate, and avoided the Romanian cycle of failed macro-economic stabilisation plans.

*Privatisation*

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[40] Romanian Development Agency (ARD), 1996, *La Roumanie, Oui! Guide A L'Usage Des Investisseurs Etrangers*, Bucharest: ARD, pp. 100 - 101

The main Romanian privatisation programme was represented by the so called 'mass privatisation'. In preparation for privatisation, the state owned corporations were divided in two categories, approximately equally. One of the categories includes the companies to be privatised, which were transformed in stock corporations (wholly owned by the state), and the other half is represented by the strategic ones that are to be kept in the property of the state and were transformed in *Regii Autonome,* under administrative direction of governmental departments. This latter category includes the railways, mail, defence industry, roads, port facilities, and telecommunications[41].

The mass privatisation programme aimed to gratuitly distribute to the population one third of the stock of the companies due to be privatised. In this goal, there were created three Private Ownership Funds - FPP (that received 10% of the stock of the commercial companies each) and the State Ownership Fund (FPS) that possessed 70% of each privatisable company. The (over 18 years old) population received property certificates (for which only a minor administrative charge had to be paid) that were to be used to acquire the shares of the Private Ownership Funds.

The Privatisation Law was passed in 1991[42]. The Ownership Funds were established and the certificates were distributed in 1992. But the government resulted from the September 1992 elections decided to review the privatisation

[41] ibid., p. 86
[42] ibid.

process, that was ultimately halted. The government was worried that apparently many people preferred to sell their certificates instead of waiting for investing them, and that allegedly a relatively few number of people acquired a large number of such certificates. Therefore in 1995 (after one year spent in Parliament), the "Law for the Acceleration of Privatisation" (55 / 1995) has been passed. The law declared void the privatisation certificates and replaced them with nominal, non-transferable privatisation coupons. In addition, the law banned the access of mutual funds to these coupons. In these conditions, the mass privatisation was launched in the Fall 1995, and after prolonging the deadline for subscription till Spring 1996, 80% of the owners of coupons subscribed them to one of the companies, or to one of the three Privatisation Funds (that are to be transformed in Investment Funds). To date, the huge majority of the new share-holders did not receive their shares, and the dividends paid for 1996 have been meagre. Moreover, the stock exchange (and the over the counter market) were only slowly gaining momentum so that the liquidity of the shares would have been limited anyway.

There have been used three other methods of privatisation. First, it was possible for large investors to acquire the package of shares by direct negotiation with the State Property Fund. This has been the method used by the foreign investors. Secondly, the Private Ownership Funds have offered for subscription their stocks in a number of companies in the terms of the 1991 law. This possibility has been used especially by those who bought certificates that were to be annulled by the new privatisation law. Thirdly, the most successful privatisation method has been MEBO - Management and Employees Buy-Out. This method was introduced by the 1991 - 1992 government (Stolojan), was standardised in the law 77 / 1994[43] and resulted in the privatisation of a large number of small and medium-size companies to the employees. The relative success of this method could be accounted for by the fact that on one hand it favoured the interests of insiders, therefore avoiding the obstacles to privatisation raised by the management and the unions, and on the other hand was popular with the electorate as it is consistent with a largely shared sentiment of justice (people who created the factory, and worked in it are now going to own it).

After the change of government in 1996, the privatisation process has speeded up. The process has been decentralised, local branches of the State Property Fund have been allowed to sell directly local small and medium size entreprises. The State Ownership Fund is expected to dissolve itself at the end of 2,000. However, even if this task will be accomplished, the big utilities and public monopolies (like air travel and railways) will remain to be privatised.

Hungary had the speediest and most straightforward privatisation process in the whole region. It is the only country that was not tempted by 'mass privatisation' schemes and preferred to sell on cash, to the highest bidder – mainly foreign companies. With hindsight, this approach is now considered a success, as mass privatisation is considered to have failed to achieve an effective change of incentives and thus the restructuring of privatised companies. More details on ungarian privatisation are presented in the section dealing with FDI.

[43] ibid., p. 89

### 4.2. Legal and Institutional Framework for Foreign Direct Investment

*Romania*[44]

The first institution foreign investors had to deal with was the Romanian Development Agency. ARD was created in 1991 and it is practically an agency for the promotion of foreign investment. It was organised in the period 1991 - 1992, with the support of the EU PHARE programme and the British Know - How Fund. Its activity consists of providing general information about the Romanian legislative and economic environment to the potential investors, individual consulting - organising meetings and contacts with Romanian partners, assistance in negotiations, and assistance for complying to the required registration procedure - and after-care for smoothing the contacts with Romanian authorities and assistance with the difficulties encountered after the start of the investment. A further role of the Agency, more in accordance with its name as a development agency, was prevented by the lack of an industrial policy of the government[45].

For those foreign companies interested in acquiring an existing plant, rather than creating a greenfield investment, the next stop after the ARD registration procedure is the State Ownership Fund, that manages 70% of the stock of the companies open to

[44] based mainly on ARD, *Investing in Romania – 2000*, Bucharest 2000
[45] Bonciu, op. cit., p. 79

privatisation[46]. FPS is the institution officially charged with the negotiation with the potential investor. According to the Privatisation Law, FPS was under the supervision of the Parliament, even if its head was appointed by the government from its own ranks, but in 1998 the Fund was transferred under government authority. In practice however, the negotiations involved apart from FPS the governmental ministries too.

Foreign investment in Romania is governed primordially by the Law of Foreign Investment, passed in 1991, and amended in 1993. Law 35 / 1991 provides the registration procedure for a foreign company willing to invest in Romania.

The first step is filing an application with the Romanian Development Agency (ARD). The application should include a copy of the investor's latest financial statement. The ARD is obliged to respond to the application within 30 days by issuing a confirmation. If no response is received during this 30-day period, confirmation is automatic. The memorandum of association and the articles of incorporation have to be legalised (by a *notar*). Within 15 days after the legalisation, the memorandum of association, together with the articles of incorporation and the confirmation of the ARD have to be filed with the district court for the proposed company's registered office. The court is to issue an authorisation for the establishment of the company. The court ruling shall be published in the Romanian Official Gazette. Registration shall also be performed with the local office of the Registrar of Companies ("Registrul Comertului") and with the local taxation office. Once the registration procedure is complete, normally within five to six weeks, a foreign investor is entitled to an Investor Certificate issued by ARD, indicating its status as a foreign investor. In the

[46] ARD, 1996, op. cit., p. 91

case of a joint venture where the Romanian partner is a state-owned company, whose assets belong to the State Ownership Fund (70%) and to the Private Ownership Fund (30%), the consent of these two funds is also necessary in order to establish a partnership[47].

Romanian legislation provides no limits to the share owned by a foreign investor. It also guarantees the full repatriation of profits, and of the revenues from the liquidation of the investment[48].

The restructuring of the Romanian taxation system after 1990 attempted to make it compatible with a market economy. The major changes in the taxation system include:

- the implementation of Value Added Tax (VAT) on July 1, 1993, replacing the former cascade turnover tax;
- the new system for wage and salary taxes;
- a new corporate tax system,
- Agreements for Avoidance of Double Taxation and Agreements for Mutual Protection of Investments.

The major types of taxes are briefly described below, together with some of their characteristics.

[47] ibid., p. 19
[48] ibid., p. 18

Corporate taxation used to be 38% and starting from 2000 has been reduced at 25%. Taxpayers obtaining at least 80% of their incomes from agricultural activities has also been taxed at a rate of 25%.

The main categories of tax deductibles are:

- depreciation, within certain limits ;
- entertainment, advertising and promotion expenses, within 3% of taxable profit
- sponsoring expenses, up to 5% of taxable profit;
- interests paid.

There are also provisions for the loss carryforward. The annual loss as it is stated by the taxpayer is recovered from the monthly taxable profit derived within the next fiscal years, but not exceeding 36 months.

Regulations also refer to the fiscal deductibility of provisions. The Government Decision No. 335/1995 stipulates that companies (except banking companies and specialized financial institutions) can constitute fiscal deductible provisions for:

- bad debts, when debtors are declared bankrupt;
- losses resulting from exchange rate differences.

Beside a risk fund, banks can constitute specific risk provisions for credits and interests:

- "loss" credits up to 100% of their balance;
- "doubtful" credits up to 50% of their balance;
- “substandard" credits up to 20% of their balance;
- "watch" credits up to 5% of their balance.

The profit tax was paid quarterly till the 25-th day of the first month of the next quarter. Lately, the government moved its payment monthly.

Tax and duty incentives offered to foreign investors has been regulated by the following laws:

- Law No. 35/1991 on foreign investments;
- Law No. 66/1992 on facilities granted to foreign investors in the field of oil and gas exploration and exploitation;
- Law No. 71/1994 on granting supplementary facilities to foreign investors in industry;
- Government Ordinance No. 3/1992 on value-added tax;
- Government Ordinance No. 70/1994 on profit tax;
- Law No. 73/1996 on profit tax;
- Law No.134/1995 on petroleum.

Law No. 35/1991 represents the general framework that can be applied in principle to all foreign investments. According to the provisions of this law:

- machines, equipment, installations, means of transport and any other contributions in kind or bought from the paid-up capital of the foreign investor are exempt from customs duties, and from paying the VAT due for imports (according to Government Ordinance No. 3/1992 on VAT);
- raw materials, consumables, spare parts and major subcomponents necessary and effectively used in production are exempt from custom duties for a 2-year period,

running from the date when the production units were established. These goods are also exempt from the VAT due for imports.

Law No. 66/1992 is applied only to foreign investments in the field of exploration and exploitation of oil and gas resources and it contains provisions concerning:

- facilities referring to profit tax paid by the Romanian side on behalf of the foreign investor.
- customs duty exemptions for:

  imports of goods made by foreign investors or their subcontractors,

  exports of oil and gas quotas representing the foreign investor's share of the production, as well as the goods imported by the investor himself and the foreign personnel.

  imports of household and personal goods necessary for the personnel working for the foreign investor.

Law No. 71/1994[49] provided special facilities for companies that invested more than $ 50 million in the industrial sector, and in a period of up to 7 years achieved a local content standard of minimum 60% local integration (value added in Romania), and 50% of the output is exported[50]. It contained the following provisions:

- customs duty exemption during a 7 year-period after the company registration for the machines and equipment

[49]The Law is known as the "Daewoo Law" as its terms are held by many to have been drafted to suit the Korean concern Daewoo's acquisition of the Craiova automobile factory in 1994, the largest foreign investment in Romania at the time.
[50] Arthur Andersen, op. cit., p. 8

- imported for the investment, brought into the business as contributions in kind or paid out of the investor's own resources;
- customs duty exemption during a 7 year-period after the company registration for the raw materials, consumables, spare parts and subcomponents. These categories above are also exempt from paying the VAT due for imports.
- tax exemption for a 5-year period starting with the date when the first profits were made, but not longer than 7 years after production activities were started.

The tax on profit was reduced for the following cases:

- proportionally with the ratio of the handicapped people hired by a taxpayer, for such taxpayers with more than 250

- employees and which has at least 3% from the total number of employees as handicapped people;

- with 50% for taxpayers who derive incomes in hard currency from the export of goods from their own activity, from rendering of international services, for the share of the taxable profit which corresponds to the weight of such incomes within the volume of total incomes;

- with 50% for the profit used in the current fiscal year to modernize the production technologies and to expand the activity with a view to obtaining additional profits, as well as for investments made for the protection of the environment.

Law No.134/1995 - applies only to foreign investments in the field of exploration and exploitation of oil and gas resources, concerning:

- customs duties exemption for the imports necessary for the execution and exploitation operations effected by the foreign investor or its sub-contractor;

- customs duties exemption for the imports of household and personal goods necessary to the foreign personnel of the investor,
- customs duties exemption for the export of shares of oil and gas due to the foreign investor as a result of production sharing, as well as of the export of goods imported by the foreign investor himself and its personnel.

Most of these facilities have been cancelled by the government from 1999 onwards, initially on provisional basis, and from 2000 permanently. The only ones kept in place are the facilities for investment in deprived areas, for profits obtained from exports, and for the import of capital goods for the investment.

Income tax on individuals was regulated by Law No. 32/1991 on individual income tax and Government Ordinance No. 70/1994 on profit tax.

Salaries paid in cash or in kind received by employees from natural or legal persons who reside or whose registered office is based in Romania, as well as the salaries received from abroad by natural persons working in Romania fall under the income tax law.

The 183 days rule applies to foreign employees working in Romania, in compliance with the provisions of the agreements for avoidance of double taxation concluded by Romania.

Individual income taxes are levied at progressive rates between 5% and 60%, in several taxation brackets.

Taxes on payrolls were regulated by Law No. 3/1977, Law No. 1/1991 and Law No. 49/1992. Taxes paid by employers are:

- social security contributions at rates between 23% and 33%, according to the job category;
- unemployment fund contributions at a rate of 5%;
- health fund contributions at a rate of 2%.

Taxes are calculated by applying the respective rates to the total gross amount of salaries paid by the employer every month. Taxes paid by employees are:

- pension fund contributions at a rate of 3% (levied on the monthly gross income);
- unemployment fund contributions at a rate of 1% (levied on the monthly gross income).

Income tax on non-residents was regulated by Decree No. 276/1973, amended by Decree No. 125/1976 and the Government Ordinance No. 70/1994. Non-residents in Romania are defined as natural persons living permanently abroad or spending less than 183 days in Romania during any 12-month period starting or ending in the calendar year under consideration, as well as legal persons whose registered offices are not in Romania.

Income taxes on non-residents were levied at the following rates:

- 15% for interests on commercial credits and for commissions paid in commercial transactions;

- 15% for incomes resulting from providing services such as technical assistance, personnel training, quantity and quality control of goods, expertise, scientific or technical consultancy, medical advice or any other services actually provided in Romania;
- 15% for air or water transports;
- 20% for incomes resulting from franchising or exploiting patents, licences, trademarks and other royalties;
- 25% for incomes resulting from artistic or entertainment activities, except incomes paid as salaries to employees.

Since 2000 the new tax legislation on global income came into force. It applies to all Romanian residents. Special tax rates are provided for income from dividents (taxed at 10%), bank interest and mutual fund investments (taxed at 1% of gross payment), and income from rents.

In addition, since 1999 a new structure of the health system was introduced. This changed the financing of health expenditure: the employee and the employer each pay 7% of the employee’s wage to the health fund. This percentage is compensated accordingly with a reduction in income tax.

Value added tax (VAT) was introduced in Romania in July 1993. The taxable operations are:

- supplies of goods and services;
- transfer of real estate property;
- imports of goods and services.

The value added tax standard rate in Romania was initially 18%, later increased at 22%. Special rates of 9% (than 11%) were applied for: essential foodstuffs (meat and meat products, milk and milk products, fish, edible oil, fruits and vegetables, eggs, flour, rice, etc.), medicine and medical equipment; advertising through newspapers and magazines, public transportation. Zero percent was applied for exports of goods and services.

There are also exemptions from VAT:

- health-care units and social security institutions;
- education, science, culture, sport institutions within the general education, high school, higher education, vocational training, as well as private lessons taught by natural persons;
- saving banks, mutual funds, credit societies, exchange offices;
- securities agencies, trading shares, debentures, bonds and securities, as well as other financial instruments;
- other legal persons authorized to perform financial transactions or with financial instruments;
- insurance and reinsurance institutions, inclusively those intermediating such activities;
- regies autonomes (public monopolies): "National Lottery", the "Official Gazette", "State Mint", "National Bank Mint";
- National Bank of Romania
- banking societies for certain transactions
- operations which enter within the scope of the tax on shows, tax on gambling or lottery;

- publishing, printing and selling of newspapers, with the right of deduction for the value added tax related to the paper, bought domestically or imported,; publishing, printing and selling of books and magazines, excluding the activities of publicity and advertising; broadcasting by radio and television, excluding the activities of publicity and advertising;
- leasing of land and renting of buildings and equipment of agricultural utility;
- operations of selling the industrial waste (debris) and recyclable materials as well as the intermediary operations: sorting, pressing, handling, depositing and transport.
- selling of lands excluding land for constructions ;
- the equity contributions to commercial companies by way of goods and services.

As I mentioned above, are also exempted from VAT some imported goods or services :

- import of goods which are exempt from customs duties
- machinery, equipment, installations, means of transport and any other outfits, used as equity contribution in kind or are purchased from the equity contribution of the foreign investor
- goods imported under the duty-free regime or sold in special shops for the use of diplomats or the staff of diplomatic offices;
- goods introduced into the country without the payment of the customs duties, according to the customs regime applicable to individuals;

- imported goods and services coming or financed from aids, grants or nonreimbursable loans granted by foreign governments, international institutions, non profit and charity institutions,
- means of transport, goods and merchandise coming from abroad and introduced directly in a free zone (according to Art. 13 of Law no. 84/1992 of the free-zone regime).

For rented imported goods, as well as for publicity and advertising services, consulting, studies of different kinds, research, the use of or the right to use any copyright, patent, trade mark, leasing, license right and any similar rights performed by a supplier having its head office or domicile abroad for customers having a head office or domicile in Romania, the VAT is paid by the customers.

The taxable base is the full amount or value of consideration received by the supplier for the supply, exclusively the VAT itself.

Deferred VAT is granted when capital goods and raw materials are imported under an incentive certificate issued by the Ministry of Finance. The VAT that should normally be paid at Customs is deferred and balanced with the VAT that is reported and paid.

In 2000, as part of a tax cut package, VAT has been reduced from 22% to 19%, while all special rates has been abolished. The government contemplates the further reduction of the VAT rate to 16% by mid Summer.

Special consumption taxes are regulated by Law no. 42/1993 on excise duties and subsequent frequent amendments to the law. Excise taxes affect the trade in alcohol, cigarettes, luxury goods, cars and home electronic products.

Starting with 1996 the distribution of cigarettes and alcoholic products is regulated by Ordinance No. 23/1995 regarding the implementation of the labeling system for cigarettes, tobacco products and whisky. The labeling system consists in affixing stamps, banderoles or labels. The liability to affix the stamps belongs to the producer or importer. The stamps, banderoles or labels are released on a nominal base upon a bill of order to each company that has a license of manufacturer or importer. The system has been further changed in January 1999.

Local taxes and duties were regulated by Law No. 27/1994. The main local taxes and duties are:

- taxes on buildings. Natural persons pay 1% of the total value of the building every year (an amount ranging between 2,000 and 16,800 lei/sqm, according to the location of the building, the building materials used and the utilities it is equipped with – central heating, electric installation, plumbing system etc.). Legal persons pay 1.5% of the book value of the building every year, irrespective of any other criteria (location, building materials etc.). The same tax (1.5%) is levied from natural persons for the buildings that they have registered as locations for company registered offices or for other economic activities.
- taxes on land covered with buildings. Owners, natural or legal persons, pay an annual tax in a fixed amount per square meter, differentiated according to its location

in cities, towns or villages, and within them, in different areas, such as the centre, residential districts or the outskirts.

- taxes on means of transport. Owners, natural or legal persons, pay an annual tax on their means of transport in a fixed amount, according to the engine cylinder capacity for each 500 ccm or fraction of 500 ccm, depending on the type of vehicle (bicycles equipped with engines, motorcycles, scooters, tractors, buses, trucks, cars etc.).

- taxes for using promotion, advertising and posting:

taxes for promotion, advertising and posting advertisement, in a fixed annual amount,

taxes for the posting of the company signs at the location where its activities are carried out.

For signs, advertisements, posters and promotion presented exclusively in a foreign language, the above-mentioned taxes are five times higher. For advertising and promoting cigarettes, tobacco products or alcoholic drinks by any means, taxes are increased by 500%.

For advertisers the taxes levied amount to 10% of the value of their contract, while for those doing promotion in other conditions (without a contract) the taxes levied amount to 12% of their gross income.

The new law on Public Local Finances from 1999 has increased the share of taxes that remains with the local government, and widened the scope for local taxation.

Stamp duties are regulated by Government Ordinance No. 8/1995. Stamp duties are paid by natural or legal persons who perform transactions which require the stamping of the legal documents giving rise to those transactions. Stamp duties are levied for the notarization of the contracts and deeds concluded at the sale and purchase, exchange or donation of immovable property.

The tax base for levying the stamp duties is represented by the value declared by the parties, but this should not be lower than the tax base used in computing other taxes for the same items. In order to notarize and have all the sales and purchase contracts that can be assessed in cash recorded in the public registers, a fixed stamp duty representing 2% of the total value of the contract is to be levied.

The taxation of agricultural activities is regulated by Law No. 34/1993. All the natural and legal persons who own farmland have to pay agriculture taxes, with the exception of those who also pay income taxes. The annual taxable income is determined according to income norms per hectare, also taking into account the fertility area, the favourability area and the land category. The annual tax is levied at a rate of 15% from the annual taxable income calculated according to the above-mentioned norms, except for the years 1994, 1995 and 1996, when the rate was established at 10%. The tax is currently suspended for 3 years.

*Hungary*[51]

[51] Source: Ministry of Economic Affairs

In the region, Hungary enjoys the image of a relatively high tax country. Hungarian indices on income-deduction and redistribution are lower than those of France and Holland, and approach those of Austria and Germany, being 3-6% higher when compared to the United Kingdom and Ireland. The ratio of taxes on consumption as a whole (VAT, fiscal and consumption tax) is high on a European comparison. It exceeds by about 3 percent the average tax customary in the countries of the OECD and the European Union. The ratio of taxes on consumption to GDP is lower in all the neighbouring countries.

The ratio of income taxes, however, amounts to only two-thirds of the OECD and EU-average. The ratio of income taxes compared to GDP is similar in Germany, Greece, Czech Republic, Spain and France. This different Hungarian ratio of taxes on consumption and incomes can be traced back to several reasons. The low proportion of income taxes is mostly attributed to the relatively low wages, but the black economy also has a part in it. However, if the social insurance contributions and the employment-connected contributions are also taken into account, the direct burdens on incomes do not fall behind the OECD or the EU average.

Similar to what we discussed in the Romanian case, there are two kinds of taxes: centrally imposed ones (value-added tax, consumption tax, excise tax, import duties, various transaction taxes) and taxes levied by local authorities (such as local business tax, taxes on vehicles and real estate).

As the base, the rate of corporate tax is 18 %, the tax base being the profit before tax. A 20% tax is imposed on dividends withdrawn or transferred abroad unless the dividend is reinvested or used to increase the registered capital of an existing company. For foreign-owned companies the provisions of bilateral agreements on avoidance of double taxation are applied.

A 50% tax allowance is available for an investment project aiming to establish production facilities commenced after December 31, 1995 and valued at a minimum of HUF 1 billion (about USD 4 million), within a period of five tax years, starting from the year the facilities opened up for operation. The tax allowance is available in each tax year when net sales grow by at least 5 % of the value of the investment as compared to the previous tax year, or in years when net sales reach a level that could have been reached if net sales had grown continually by 5 % of the investment value over the preceding tax years.

A 50% tax allowance is available for investments aiming to establish hotel facilities commenced after December 31, 1996 and valued at HUF 1 billion (about USD 4m) at least, within a period of five tax years, starting from the year the facilities opened up for operation. The tax allowance is available in each tax year when net sales grow by at least 25% or at least HUF 600 million (USD 2.5m) as compared to the previous tax year or in years when net sales reach a level that could have been reached if net sales had grown continually by 25% (or HUF 600m) at least over the preceding year. The preferences are available until after the 2002 tax year.

Companies will receive a 100% tax allowance for 10 years over net sales earned at productive facilities established for at least HUF 10bn (USD 40m) started after December 31, 1996. The allowance is available for each year when net sales, compared to the previous tax year increase by at least 5 % of the value invested or in the years when net sales reach a level that could have been reached if net sales had grown continually by 5 % at least of investment value over the preceding tax years. The allowance is available only from the second year after the facility opened up for production and only for years when at least 500 or more persons are employed (on a yearly average) than in the year preceding the commencement of the investment project. The preference is available until after the 2011 tax year.

Entities registered or located in a high priority region and/or in an entrepreneurial zone are entitled to a full allowance in respect to that part of their corporate tax that is calculated on the basis of net revenues earned by new production or hotel facilities established and operated in that particular high priority region or entrepreneurial zone after December 31, 1995.

A production facility in an entrepreneurial zone is entitled to the allowance over a period of five tax years for each year when net sales increase by 1 % compared to the previous tax year.

A production facility in a high priority region is entitled to the allowance over a period of five tax years for each year in which net sales increase by at least 5% compared to the investment value. A hotel facility is entitled to the allowance over a period of five tax years for each year. These allowances are available until after the 2002 tax year.

Companies registered or located in an underdeveloped area of Hungary receive a 100% tax allowance for 10 years, based on proportional value of net sales earned at productive facilities established by an investment of at least HUF 3bn (about USD 12m) started after December 31, 1996. This preference is available for each year in which net sales, compared to the previous tax year, increase by at least 5% at least of the investment value, or in years in which net sales reach a level that could have been reached if net sales had grown continually by 5 % of the investment value over the preceding years. This tax allowance is available only from the second year after the facility opened for production and only for years in which at least 100 or more persons are employed (on a yearly average) than in the year preceding the beginning of the investment.

The allowance is available if the taxpayer's registered location or premises and its productive investment is located in a region where unemployment exceeds 15% in any of the two years preceding the commencement of the investment project. The preference is available until after the 2011 tax year.

A tax preference of 6% of the investment project is available for companies located and registered in a high priority region on the value of the machinery installed and buildings installed and operated in that particular region in the year in which the investment facility is opened up.

A tax preference of 6% of the investment project is available for companies installing an infrastructure project in a high priority region or an entrepreneurial zone in the year in which the project is put into operation.

These allowances will be available until after the 2002 tax year. An annual 10% of the audited purchase value of buildings and machinery can be deducted from the profit before tax.

The Tax Law specifies the tax rate for offshore companies as 3 % of the tax base. Enterprises are hit hardest by high employers contributions, for guarding the safety of the financing of the social insurance funds.

For next year, the government attempts to bring about the reduction of administrative burdens for enterprises. From among the planned amendments to the act on VAT, one is aimed at increasing the income limit of the annual VAT return to HUF 8 million from the current HUF 3 million. The measure would affect about 30 % of the VAT-subjects and would reduce the number of those who file quarterly VAT returns by 92,000. The proposal would favourably affect most of those concerned, who will have to pay their VAT later, simultaneously with their yearly tax return, until February 15, following the base year. From among the economic associations about 45,000 (17,000 limited companies and 28,000 partnership companies) would have to account for VAT only once a year.

Employers' participation in their employees' pension fund savings will be promoted by, in the case of the voluntary mutual pension fund payments, making the contribution of employers tax-free up to 115 % of the monthly minimum wage. At the same time the tax allowance on the payments into the voluntary mutual pension funds would decrease to 30% from the current 50%.

### 4.3. The Evolution of Foreign Direct Investment

As the table from the appendix shows, there is not a clear pattern in the evolution of the FDI flow in Romania. The flow varies from a minimum in 1990 (106.7 million $) to a maximum of about one billion in the last years of the decade. One obvious element that can be noticed is the relatively low value of the capital invested in Romania, even in comparison with other CEE countries, and especially with Hungary.

In trying to explain the fluctuations of the flow of capital it is difficult to identify the root causes. The interviews I hold did not reveal a very clear reason for the timing of the investment. Most opeople I interviewed pointed to reasons internal to the multinational, like their global strategy or the strategy of expansion in Eastern Europe. Another explanation offered was the need to wait for a few years after the violence and instability of 1989 - 1990 to see how things are evolving. One has however to bear in mind that the expansion strategy is not decided by the Bucharest offices, but by the general or European headquarters. Another consideration is that a single deal can have a big influence on the yearly performance: e.g. the elatively good result of 1995 is largely due to the arrival in Romania of the Korean concern Daewoo, the single largest investor in Romania at the time, and which acquired one of the automobile plants of the country - the Craiova Oltcit plant that used to produce a Romanian version of Citroen. Subsequently, Daewoo diversified its holdings in Romania by buying the second largest ship building plant of the country at Mangalia (port at the Black Sea), creating a Daewoo Bank (opened in the Spring of 1997) and a real estate holding.

Also, in 1998 the privatisation of the phone monopoly represents one third of total FDI flow – the largest deal to day.

An insight over the timing of the investment decision seems to be offered however by the evolution of the Romanian macro-economic data. 1992 was the first year of relative successful macro - stabilisation with the first positive real interest rate and an improved trade balance. The rush in 1993 of the newly elected government to increase the industrial output at the price of restructuring, and the failure to come to an agreement with IMF resulted in the worst annual inflation rate in the whole transition process. 1994 and 1995 are years of better economic performance, with 1995 recording a strong output increase, but 1996 has again seen a deterioration of the macro-economic situation even as foreign investment surged. After 1997, we witnessed a slight stabilisation both of the macro-economic situation and of the FDI flow (see table in appendix).

The best performancewas however in 1997-1998, and this requires an explanation. The best one seems to be offered by political rather than economic factors. The new government that came to power in the Autumn of 1996 was well received by the business community. These high hopes were dashed away after the government honeymoon passed, and when the emerging markets crisis changed the international investment climate, and investors perception of the risks incurred.

In conclusion it is difficult to identify one key predictor for the evolution of FDI flow, but the macroeconomic evolution seems to have an important influence if not on the investment decision, at least on the moment of the investment. The data also suggest that investors clearly do not react to macroeconomic data with a three year lag, as is the case with most of the investment motivation factors analyses by Lecraw.

Yet, here as everywhere else there is the question of the reliability of statistics. The recording standard of the Romanian Development Agency is to register an investment when the agreement was signed, even if the actual capital will enter the country only gradually during a large span of time. Moreover, ARD recording procedure takes into account only the initial investment, neglecting the value of the re-invested profits and non-equity capital. When these two elements are taken into account it is estimated that the current total stock of foreign capital would raise.

One interesting feature of the foreign investment in Romania (but that is actually present in the other CEE countries as well) is the rather counter-intuitive predominance of foreign investment by acquisitions of state companies rather than by creating new, greenfield investments[52]. One could expect that the foreign investors would prefer to build a new plant, with up to date technology and facilities. Thus they would avoid the potential obstacles of dealing with hostile trade unions and managers who are afraid that the restructuring of their obsolete plant will result in large redundancies.

[52] Bonciu, op. cit., p. 79

Against these expectations, foreign investment in Romania is centred around privatised companies. This is also the situation in most other Central Eastern countries, and explains the correlation between the level of privatisation and the stock of foreign investment in these countries.

There are several possible explanations for this evolution. One is that the privatised companies are extremely cheap and therefore it pays more for an investor to buy such a company rather than to build a new one. In addition, the government may be willing to grant substantial incentives for the investor in order to get reed of a troublesome company, that might record huge losses but whose closure would have politically too high social costs (a good example in Romania is the very favourable treatment received by Daewoo which took over the Craiova Oltcit automobile plant). Secondly, as many investors are interested in the domestic market, buying a state company eliminates a potential competitor. Third, a privatised company posses already a trained labour force and a distribution network that would be expensive to create from scratch.

These elements seem to compensate for the risks involved in taking over an over-staffed plant, with vocal trade unions. In Romania, the experience in this field is mixed. On one hand there is the widely publicised failure of the privatisation of the large Bucharest-based agricultural machines plant Semanatoarea to the New Holland group (Fiat subsidiary). As the investor wanted to take over only a part of the work force, there was a conflict involving the two trade unions: the one representing people who will maintain their jobs is in favour of the privatisation, while the second (larger) opposed it. Eventually, New Holland gave up.

There are also successful cases, where the foreign investor succeeded to manage better the relations with the trade union and the privatisation process went smoothly. One such a case is the Craiova Daewoo plant, where the wages are 30% over the industry average, large training programmes are in place, and the trade unions are muted (even if there were complains that the wages are much bellow the South Korean level). Another success story is the Timisoara Procter & Gamble Plant, where even if the investor took over only a part of the plant (and therefore only a part of the work force) there have been recorded no problems.

For many companies, Romania is assimilated rather to the Balkan and / or former Soviet Union area (e.g. Ukraine). And it is in this context that Romania enjoys certain comparative advantages, which make it attractive as headquarters location and primordial investment choice: Romania has the advantage of the political stability and relative low risk, when compared with former Yugoslavia and Ukraine (and lately with Bulgaria), and in comparison with Bulgaria the size of the potential market is more than double due to its 22.7 million inhabitants. In addition, living in Romania seems to be more enjoyable (or less annoying) than in the other countries due to cultural reasons (better knowledge of foreign languages, especially French), and the low rate of violent crime.

Being interested in the domestic market, many companies enter Romania first through their sales divisions. Only if the market for their products is large enough are they going in the second step to invest in production facilities in the country. A good such an example is Procter & Gamble that arrived in Romania in 1992 with the salesmen, upgraded its branch with a full management team in the Summer of 1994, and then decided to establish the headquarters for Balkans and Ukraine in Romania. In the fall of 1994 the company opened the negotiations with the Fund of State Property for the acquisition of a part of the Timisoara detergent factory, that was opened as a Procter & Gamble plant in May 1997, and is supplying the whole region.

Some companies need to create the market through an education campaign of the consumers, or to wait for their (larger) competitors to create the market for them.

Other companies (e.g. Unilever) come and open directly the production facilities, based on an existing market (e.g. detergents), and on the co-operations that they (or similar companies) had with the respective Romanian company during the communist regime.

Finally, some companies are interested in the fields were Romania has acquired experience. It is the case of Daewoo which bought an older car plant or of the oil industry were Romania has an old tradition as the former second largest and oldest European oil producer.

Turning now to Hungary, both in absolute terms, and on a per capita basis, Hungary has been the preferred destination among eastern European countries for foreign direct investment since the beginning of the transition to a market economy[53]. Between 1989 and 1997, almost USD 18bn was invested in the country, equivalent to over USD

1,800 per person (almost twice the per capita FDI in the Czech Republic and nine times that in Poland).

Forty per cent of all FDI into the region ended up in Hungary and there are now some 25,700 companies with foreign stakeholders operating there. They produce about 32% of Hungarian GDP, 45% of manufacturing value-added and employ 25% of private-sector workers.

Initially the inflows went into joint-ventures with private Hungarian and state-owned enterprises. Greenfield investments became important after 1992, following the success of earlier investments and the introduction of government incentive programmes. Beginning in 1995, strategic investments in privatised firms dominated, while most recently, non-privatisation investments, including both greenfield projects and the expansion of existing capacity, represent a large share of the total. FDI revenues more than financed the external current account deficit for the past three years. At the same time, privatisation revenues have been used to pay off some of the government external debt.

FDI has also played an important role in enhancing economic efficiency. Firms with substantial foreign participation have enjoyed tremendous success. Although most are not export-oriented, they produce an estimated 72% of Hungary's gross exports. Foreign-owned firms have also experienced the most rapid gains in productivity and employment.

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[53] Based on OECD, *Economic Survey – 1999*, 2000

In the trade sector, the exports of foreign-owned firms are increasingly concentrated in high-tech and high value-added products. This contrasts with firms operating in other CEE countries which continue to be concentrated in labour- and energy-intensive industries. Indeed, a large number of firms have moved skill-intensive activities, including their research and development, to Hungary (e.g. Nokia, Knorr-Bremse, General Electric) and the share of high technology products in Hungary's total foreign trade is growing.

The inflow of FDI did not occur in a vacuum. Even before the transition began, public policy was relatively favourable towards foreign investments. Since 1989, this openness was expanded and government policy played an active role in attracting such investments. In addition to flexible regulation of FDI (foreign and domestic-owned firms have been treated on the same legal basis since 1993), a number of special concessions and financial incentives were offered by both the central and local levels of government. The largest sums of FDI were attracted by the government's post-1995 privatisation policy, which emphasised the sale of state-owned enterprises to foreign-based strategic investors. Over the past ten years, about 1,600 companies have been privatised, yielding USD 11bn in revenue, of which USD 9bn was provided by foreign purchasers representing about 40 % of all the FDI that has entered the country. While one of the principal motivations behind this policy was to gain access to foreign currency in an effort to reduce the foreign debt of the country and finance the current account deficit, it also helped establish a clear corporate governance structure for the newly-privatised firms.

Among privatised companies with foreign stakes, the pace of restructuring, and of productivity and market growth, was much higher than that of privatised companies without foreign involvement. State-owned companies sold to foreign owners were much more likely to reduce employment levels than state-owned companies or ones sold to a domestic owner and their overall performance was better than that of domestic firms. These micro results are reflected in aggregate data, which indicate that across manufacturing sectors, groupings with higher shares of FDI have enjoyed higher rates of productivity growth.

After 1992, greenfield investments began to play an increasing role in overall FDI. Initial capital investments were made by large multinationals such as Ford, Opel, Audi, Thyssen, Knorr-Bremse, IBM, Nokia and Philips, who set up assembly plants to service the western European market.

A liberal policy towards the establishment of industrial free trade zones played a large role in attracting this kind of investment in the early 1990s, when import tariffs were relatively high. After 1995, when the duty-free treatment of investment-related imports of foreign firms was abolished, there was an even larger surge among investors to establish such zones. Unsurprisingly, the share of exports accounted for by firms in these areas rose rapidly. In 1997, 97 % of their exports came from the machinery sector, where their share in total exports was about 58 %, representing 75% of the overall increase. Although firms are paying high wages within the context of the Hungarian labour market, labour costs remain relatively inexpensive compared with those in the West.

Despite the dominant position of FDI firms in the export sector, survey evidence indicates that two-thirds of foreign-owned firms entered Hungary — either by privatisation or through greenfield investments — in order to exploit the domestic market. This data is supported by calculations indicating that as much as 80 % of FDI was directed toward domestic opportunities, with service-sector firms accounting for 58 % of total FDI. Even among manufacturing firms, those with below-average export/sales ratios represent over 50 % of all manufacturing FDI. In some cases, the domestic component of operations is largely distribution. Within this second group of companies are Auchan, Penny Market, Cora and other firms in the retail and wholesale trade sectors. Although their initial activities may have involved relatively little interaction with the domestic economy and were concentrated in the richest market (Budapest), their business is increasingly leading them further into the hinterland, bringing with them competition, lower prices, new jobs and a different way of doing business.

The extent to which manufacturing firms have succeeded in building up domestic supply networks varies widely. Suzuki, for example, seeking to meet EU local content requirements, has built up a substantial network of domestic suppliers, whose share in value added now exceeds 30%. Opel and Ford have also made efforts but with considerably less success, with shares of domestic suppliers in total value added of only 8 %, while for Audi the share is less than 1 %.

The privatisation process itself is drawing to a close. As much as 85 % of GDP is now generated in the private sector and the number of state assets available for sale is diminishing rapidly. At the end of 1997, the Hungarian Privatisation and State

Holding Company owned stakes in 211 companies, down from 493 in the previous year, with its average holding equal to about one-third of total equity. Of those, it is legally obliged to retain its holdings in 92 companies, of which it has full ownership of 21 and between 25 and 75 % holdings plus golden shares in the remainder.

As the privatisation process comes to a close, a series of issues have yet to be resolved. While the number of assets in state hands has continued to decline, the government plans to maintain a golden share, and in some cases with sizeable participation, in a number of firms spanning a range of industries. In addition, with few assets remaining in state hands, a decision needs to be made whether the ÁPV Rt should follow a "treasury" model where it has a relatively minor role or a "holding model" where it becomes actively involved in the management of the companies it holds. The first appears preferable as it reduces the potential for political interference in the operation of state-owned firms, according to OECD.

# V. Explaining the difference in performance

## 5.1. Approach

In order to improve the understanding of investor behaviour, I have used interviews preceded by a self-administrated, mixed questionnaire. The interviwees have been field managers in multinational companies and consultancies from Romania or Hungary. In addition, in Romania I introduced in the research analists and public servants from relevant agencies. I used the interviews to deepen the understanding of the answers to the questionnaires.

The questionnaires followed the list of factors influencing inward investment as developed in Lecraw, Donald J., "Factors Influencing Foreign Direct Investment by Transnational Corporations in Host Developing Countries", in Buckley, Peter and Mark Casson, eds. 1992. I have discussed the list in chapter 3.

The factors introduced in the questionnaire were:

*country risk*

*level of infrastructure development*

*government policy towards foreign investment*

*taxes*

*domestic capital scarcity*

*domestic market: size and growth rate*

*tariffs*

*real exchange rate*

*wage rates and the education level of the work force*

*company strategy*

Each respondent was asked to identify the factors that most positively, respectively that most negatively influence foreign direct investment in the country.

**5.2. Findings**

There is apparent a clear difference of sentiment between foreign investors in Hungary and Romania. In Hungary the outlook is mostly positive. All factors register positive replies (with the exception of factor 5 – domestic capital scarcity). Most positive replies cluster however around factor 6 – domestic market and 9 – labour force, and to a lower extent to factors 1 – country risk, 4 – taxes, and 10 – company strategy. There are mixed answers for factors 2- infrastructure, 3 – government policy, 7 - tariffs, and 8 – exchange rate.

This outlook contrasts with the answers in Romania. Here the note is mainly negative. The leading negative factor is 3 – government policy, followed by 1 - country risk, 4 - taxes, and 2 - infractructure, and further behind 8 – real exchange rate. The only positive factors are 9 – labour force, and 10 – company strategy.

Factors 5 – domestic capital, 6 – domestic market, and 7 – tariffs record mixed answers.

### 5.3. Discussion

These findings emphasize the role of government related factors in influencing the flow of foreign direct investment. Government policy was most often mentioned as negative by Romanian respondents while in Hungary the replies have been mixed. The study does not find support for the claimed importance of tax incentives in stimulating the flow of foreign investment. Taxes are mentioned as negative by Romanian respondents, but in interviews the most criticized aspect has been the frequent changes in taxation, and not its level. In addition, Hungarian respondents have a mixed attitude towards taxes, in spite of their level in Hungary being comparable with the one in Romania.

A business survey from the consultant KPMG questioned how the companies active in Romania perceived the investment climate. According to this survey the three most serious obstacles encountered by the companies were bureaucracy and corruption (together with poor infrastructure). These showed up in our interviews, much stronger in the Romanian case than in the Hungarian one.

One element is the large amount of paper-work (four times as much as in a Western European country according to one of my interlocutors). This is coupled with the high number of inspections of the authorities that consume a large amount of the time of the highly paid managers. Another related element is the high number of administrative bodies the investor has to deal with. Things are complicated by the fact that on one hand the Romanian legislation lacks clarity, and on the other hand the different overlapping governmental agencies come with conflicting interpretations of those laws.

One example is the issue of land property. The Foreign Investment Law banns foreign investors from buying land. But the commercial law states that the foreign companies registered in Romania are Romanian legal entities. According to the Constitution, the Romanian legal entities are allowed to acquire land. Yet, the Supreme Court has decided in a case concerning an Italian company that a fully owned foreign company cannot buy land[54].

The land issue was extremely controversial and emotional in Romania. Many politicians highlighted the interdiction for foreign investors to own land as a serious disincentive for investment in Romania and one of the causes of the relative few investment that the country received. Actually, the interviews I conducted do not support this view. First, Romanian law allowed land leasing for 99 years - what seems satisfactorily for the investors. Second, it is also legal for a foreign company to acquire a Romanian company which owns land, and to become in consequence a legal owner of land - this is the case with the Timisoara plant of Procter & Gamble.

A more real problem is the plurality of the financial review bodies. There are four such bodies that inspect the commercial enterprises in Romania: there is the Financial Guard and the Financial Inspectorate that belong to the Finance Ministry; in addition to these, there are the Economic Police of the Interior Ministry and the Government's Financial Revision Body (*Curtea de Conturi*) that is checking the accuracy of the revision of the other three. The confusion of the legislation and the (alleged) poor quality of the staff leads to many conflicting interpretations of the law.

Bureaucracy and administrative confusion intermingle with the lack of clarity of the legislation itself. Romania still operates under many communist laws, that are old fashioned and unfitted for a modern market economy. Moreover, the communists did not bother very much with legality and legal coherence, thus many pre-communist laws have not been abrogated and legally they are still valid. The third layer of legislation, the post-1989 one, did not succeed to fill all the gapes and inconsistencies of the previous legislation, and seems not to have a high quality itself. For example, the financial director of a large Romanian investor told me that drawing the monthly balance sheet, according to three possible interpretations of the law, the company made a profit of 8 billion lei, or a loss of 10 billion lei, or broke even. The matter is complicated by the fact that there is not even one governmental body able to provide a clear interpretation of the law. The administration answers questions about the interpretation of a legal paragraph by re-stating the text of the law. The courts are not bound by compulsory precedents (like in a common law system) and the number of cases has not been high enough to provide credible expectations for the matters arising. The high number of laws also mean that nobody has grasped all of them and surprises abound. For exemplification, AMOCO found out that the plan of the greenfield power plant they are going to build in partnership with ABB and the Bucharest Municipality needs also the approval of the Army.

Such problems represent themselves of course an inconvenience, but they are all the more significant as they are unexpected and therefore create a climate of uncertainty, making the investors to fear many other similar surprises.

Corruption is strongly connected in people's minds with bureaucracy: the more bureaucratic requirements the more opportunities for corruption. It seems that the difference in size really matters, and for the large multinationals corruption is not so much a problem. In the words of one of my interlocutors, the large companies are above corruption. If we accept this, there are several possible explanations. One is that the small gifts required to pass through the bureaucratic hurdles bear much less heavier in the budget of a large company compared with a small one, and therefore they tend not to be perceived as a major obstacle. In addition, large companies have much more political clout. They have direct access to the highest officials, and when required they can mobilise support from the government of their home country.

Infrastructure is generally accepted to be a serious problem in Romania, even as some people admit there is a steady improvement. Telecommunications (international calls, installing quickly a new phone line), banking services (a payment through the bank requires normally three days) and the transportation (bad railways and especially roads) continue to present serious obstacles to the normal commercial activity. We could perhaps stratch the concept even further by including here the lack of adequate local suppliers – one of the complaints of a major German electric manufacturer in Hungary.

An element largely present in my interviews was the tax system. The corporate profit taxes are not perceived as remarkably high, neither in Romanian nor in Hungary. However, the personal income tax (quickly raising to the top rate of 60%) and the high social charges are considered as excessive. In Romania is even more important the taxation rule for depreciation, that assumes a longer effective life of a fixed asset than is actually the case in a modern company, and does not take into account the high domestic inflation, both resulting in much lower than necessary deductions from the taxable profit.

Another serious limitation is the 5% of the pre-tax profit limit for the deductible advertisement expenses in Romania. It is much below the real expenditure of most companies in a modern market economy. For exemplification, Procter & Gamble spends on advertisement 10% of the revenues.

In both countries, labour showed up as the most positive factor influencing the decision to invest in that country. However, in many interviews appeared the idea that while indeed Romania has a highly qualified labour force in the technical fields, it is very difficult to find competent individuals in the financial and management sectors (especially accountants) - what makes them very expensive and encourages companies to steal employees from others, many times people in which a very expensive training has been invested.

Another major reason of complains was the Romanian tariffs system. First of all the level of tariffs is rather high. Romania is a member of the World Trade Organisation. Romania has also concluded a free trade treaty with the European Union in the form of the European Agreement (concluded in February 1993, and valid since January 1995) that provide for a gradual liberalisation of trade in both ways. Romania became member in the Central European Free Trade Agreement (CEFTA). Having the status of a developing country, these agreements allow Romania a slower liberalisation of imports (except in case of CEFTA). Moreover, these treatise leave room for safeguard measures that allow temporary breaches of the upper limits. In consequence, the import duties range from hundreds per cent for luxury products (e.g. spirits) and agricultural and food products (recently reduced under 100%) to an average of 20% for the most products. Secondly, these high tariffs create market distortions, sometimes even against the commonly perceived Romanian interest. For example, a company complains that the duties are higher for importing soap constituents that for bringing in the final product.

A very interesting insight offered by the interviews is the importance of the human factor in the investment decisions. Not usually taken into consideration by academics, pleasant living conditions for the foreign managers, a welcoming attitude from the population and authorities seem to play a very important role. These criteria go as far as good restaurants, and Western standard housing facilities (even if at outrageously high prices, as it is the case in Bucharest) and the existence of international schools for the expatriate's children. Therefore the one of explanations of much higher foreign investment in Hungary in comparison with Romania, but also Poland let's say, is Budapest being a much more pleasant town to live in than Bucharest or Warsaw. This kind of motivation seems to be true especially for the initial decision to enter the market of a country, while the decision how much to develop afterwards will depend on the fiscal and the other economic fundamentals. On this criterion Romania fares badly in competition with the Hungary, and Visegrad countries in general, but enjoys an advantage when compared with its Southern and Eastern neighbours.

Interestingly, the interviews have also pointed to the conclusion that the development of trade relations with the European Union - the most important developed market in the proximity of Romania - in special in the form of the European Agreements, and the opening of negotiations for EU accession did not represent a factor taken into account by those investing in Romania. This incentive was however present in Hungary. This situation confirms the fact that foreign investors are mainly interested in the domestic market, especially in the Romanian case. Therefore, the premises for export led growth are not very promising.

Finally, there is apparent a difference of outlook between the business community and the government agencies in charge with dealing with foreign investors, the latter favouring more active measures in attracting foreign investment. These results are valid for Romania only – in Hungary the questionnaires and interviews were addressed to company officers only.

## VI. Conclusions. Policy Recommendations

The paper sprang from a concern for foreign direct investment in Romania. Similarly with the other former soviet satellites, Romanians expect that the foreign investment will be an important tool for the economic development of the country by increasing the stock of capital, bringing in new technology and know-how, and supplying the financial means needed for the social programmes aiming to cushion those hurt by the economic reforms. Therefore, the successive post-communist governments have pursued a policy aimed at attracting foreign investors. The common wisdom states that the country should be interesting for the businessmen since it is the second market of the region (more than 23 million consumers), has a good geographic position, a cheap but educated work force, as well as due to the presence of natural resources and of an industrial base. However, Romania has not been very successful in focusing the interest of the foreign investors, and 10 years after the start of reforms, the foreign investment falls short of the expectations. Moreover, the performance is all the more disappointing as other countries of the region has fared much better, especially Hungary which in spite of having only half of Romania’s population and territory has a much higher foreign investment stock.

The paper was therefore a comparaison between foreign direct investment in Romania and Hungary, with the emphasis on what public policy can achieve. The procedure I have chosen for addressing the issue was to investigate the shortcomings of the Romanian investment climate versus the Hungarian one. In order to achieve this, I focused my attention on the people who have to make the decisions: the foreign investors. The core of the paper was based on a small scale study of the business sentiment in Romania and Hungary. The data for the study was coming primordially from a series of interviews I held with managers, civil servants and analists.

The paper was structured in four chapters. Intending to put the whole issue in its proper context, the first two chapters had mainly a theoretical basis. The first chapter aimed to explain what are the reasons for a host country being interested in acquiring foreign investment. The second was a review of the theory of foreign investment. It presented an overview of the main points from the transaction cost and financial theories available. A special attention was given to the location theory that identifies the elements which are taken into consideration by a multinational when deciding to invest in a certain country.

The third chapter presented the case study on the foreign investment in Romania and Hungary. It followed a descriptive manner, attempting to account for the structure of the FDI and to find explanations for the timing of the investment, the elements which attracted the investor, and the obstacles encountered. Finally, the fourth chapter presented the empirical findings of the research.

One of the elements that must be kept in mind is the limited nature of what governments can achieve. On one hand, this limitation springs from the fact that the location factors are just one of the three groups of variables which explain the decision of a multinational corporation to invest in a certain country. The other variables are outside the host country control, and many depend on the internal dynamics of the multinational. This was present in the interviews. As I mentioned above, the timing of the investment is as much a function of the strategy of the company as of local developments. For exemplification, the decision of AMOCO to abandon the commercial activity in Romania was taken out of global strategy considerations, even if the business was developing satisfactorily.

However, the most important conclusion of the study is that the government can make a difference. The findings emphasize the role of government related factors in influencing the flow of foreign direct investment, especially maintaining a simple and stable regulatory framework, and a stable macro-economic environment. Both findings confirm the theoretical expectations, that a stable economic situation, speedy privatisation, and a simple legislative and instituional framework are the main elements favouring FDI.

The study did not find support for the claimed importance of tax incentives in stimulating the flow of foreign investment. They can play a role, as is the case with the duty-free zones in Hungary, but they cannot be relied upon to compensate for those above-mentioned.

In this context is worring the apparent difference of outlook between the business community and the Romanian government agencies in charge with dealing with foreign investors, the latter favouring more active measures in attracting foreign investment, both in questionnaires and interviews.

The conclusion of the case study is that there is a series of small measures which are both politically easy to implement, and which would have an important effect upon the investment climate of the country. Such measures include especially those dealing with bureaucratic overload and overlapping and unclarities in the legislation, which together create a climate of uncertainty. The cases presented in the study addressed the issues of rationalising and down-sizing the bureaucratic procedures (e.g. the financial control bodies), eliminating the unclarities from the legislation (e.g. over the application of VAT), harmonising the Romanian practice to the international one (e.g. in the case of the management fees), relaxation of restrictions (e.g. the limit on advertisement or obsolesce expenses, and perhaps on land ownership).

Other measures, while beneficial for increasing the foreign investment, require a more fundamental change in the philosophy of the government. This is the case with lowering the overall level of taxation and tariffs, and a sustained campaign for increasing the openness of the country towards the foreign investors. It is also the case with the factors which can be influenced only on the longer term, as it is the situation with the development of infrastructure and the focus of the education system. Tackling the shortcomings in these fields requires a shift of the governmental priorities.

Finally, a few words deserve to be said about the role of the European integration in the dynamic of the foreign investment. It is a largely shared belief in Romania that the integration in the Euro-Atlantic organisations (meaning NATO and EU) is the strategic goal of the country, not least because it will dramatically increase the attractiveness of the country for the foreign investors. It appears very surprising how little place this matter takes in the mind of the foreign investors. The only aspect that seemed interesting to them was that the integration process implies the harmonisation of the Romanian legislation with the Community one, what would provide the businessmen with a familiar and better quality legal framework. Thus, there is perhaps a rapture between the political class which has the whole attention focused towards West, and the businessmen who place Romania in their Balkan divisions, and see it as a potential base for expanding eastwards.

How this rift should be dealt with is less a clear matter: whether politicians should look at the business interests and devise policies to accommodate them, or better attempt to shape the economy according to how they see the national interest. One should not forget that Romania received a relatively small volume of foreign investment, and that this investment is predominantly the market-seeking type. Perhaps the advancement at full speed of the integration process will bring in people who were not interested in Romania before, especially investors interested in exports towards the European Union. European integration plays a an important role in decisions to invest in Hungary, so probably this will be the case in Romania too, once the accession process is more advanced.

# Appendix 1

## Romanian Main Macro-economic and FDI Data

| | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **GDP growth rate** | -5.8 | -5.6 | -12.9 | -8.8 | 1.5 | 3.9 | 7.1 | 3.9 | -6.1 | -5.4 | -3.2 |
| **Trade Balance (mil. USD)** | 2,508 | -3,427 | -1,106 | -1,421 | -1,128 | -411 | -1,577 | -2,471 | -1,980 | -2,624 | -1,087 |
| **Foreign Investment (mil. USD)** | **NA** | **NA** | **37** | **73** | **87** | **341** | **417** | **263.0** | **1,224** | **2,040** | **961** |
| **Unemployment rate (%)** | NA | NA | 3.0 | 8.2 | 10.4 | 10.9 | 9.5 | 6.6 | 8.9 | 10.3 | 11.5 |
| **Total gross foreign debt (mil. USD)** | NA | NA | 2,131 | 3,240 | 4,249 | 5,563 | 6,482 | 8,344 | 9,502 | 9,807 | 8,598 |
| **Consolidated government budget deficit in GDP** | NA | 1.0 | 3.2 | -4.6 | -0.4 | -2.4 | -2.9 | -4.1 | -3.9 | -4.1 | -4.0 |
| **Inflation rate** | NA | 5.1 | 170.2 | 210.4 | 256.1 | 136.7 | 32.3 | 38.8 | 154.8 | 59.1 | 45.8 |
| **Annual depreciation of average ROL / USD rate** | 14.5 | 50.3 | 240.6 | 303.1 | 146.8 | 117.8 | 22.9 | 51.6 | 132.5 | 23.8 | 72.8 |

Source: Romanian National Bank

# Appendix 2

**Hungarian macroeconomic data - Change over previous year**

| Items | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|
| Gross domestic product (GDP) | 4.6 | 4.9 | 4.5 | 4 - 5 | 5 - 6 | 5 - 6 |
| Consumer price index | 18.3 | 14.3 | 10.0 | 6 - 7 | 4 - 6 | 3 - 5 |
| Foreign trade turnover (goods and services) | | | | | | |
| Export volume change | 26.4 | 16.7 | 13.2 | 11 - 13 | 9 - 11 | 9 - 11 |
| Import volume change | 24.6 | 22.8 | 12.3 | 11 - 13 | 9 - 11 | 9 - 11 |
| Current account deficit (with EU transfers) (Euro billion) | 0.9 | 2.0 | 2.0 | 2,1 - 2,3 | 2,3 - 2,5 | 2,3 - 2,5 |
| Deficit of foreign trade (Euro billion) | 1.9 | 2.4 | 2.8 | 3 - 3,4 | 3,4 - 3,8 | 3,8 - 4,2 |

Source: Ministry of Economic Affairs

## Appendix 3

### Inflow of Foreign Direct Investments in Hungary
### (1990 - 1999. November, mUSD)

| Year | Equity capital | Contribution in kind | Total |
|---|---|---|---|
| 1990 | 311 | 589 | 900 |
| 1991 | 1.459 | 155 | 1.614 |
| 1992 | 1.471 | 170 | 1.641 |
| 1993 | 2.339 | 142 | 2.481 |
| 1994 | 1.147 | 173 | 1.320 |
| 1995 | 4.453 | 117 | 4.570 |
| 1996 | 1.983 | 57 | 2.040 |
| 1997 | 2.085 | 220 | 2.107 |
| 1998 | 1.935 | 11 | 1.946 |
| 1999 Jan. - Nov. | 1.341 | 5,6 | 1.346,6 |

Source: National Bank of Hungary, Ministry of Economic Affairs

### Stock of Foreign Direct Investments in Hungary
### (1991 - 1999. November, mUSD)

| Year | Equity capital | Contribution in kind | Total |
|---|---|---|---|
| 1991 | 2.107 | 744 | 2.851 |
| 1992 | 3.424 | 914 | 4.338 |
| 1993 | 5.576 | 1.056 | 6.632 |
| 1994 | 7.087 | 1.229 | 8.316 |
| 1995 | 11.919 | 1.346 | 13.265 |
| 1996 | 14.690 | 1.403 | 16.093 |
| 1997 | 15.882 | 1.425 | 17.307 |
| 1998 | 18.255 | 1.436 | 19.691 |
| 1999 Jan. - Nov. | 18.767 | 1.441,6 | 20.208,6 |

Source: National Bank of Hungary, Ministry of Economic Affairs

## Appendix 4

Summary of empirical findings in Central and Eastern Europe

| Study | Countries | Sample size | Most important motivating factors | Least important motivating factors | Problems encountered | Other comments |
|---|---|---|---|---|---|---|
| Pye (1997) | Czech Republic, Hungary, Poland, Romania, Slovakia | 334 | Access/supply local market. Market growth potential. | Access to local technology. Export base for non-European markets. Access to EU markets. | N/A | General results more or less reflect individual countries. Extensive scope. |
| Éltetö and Sass (1998) | Hungary | 123 | Obtaining/increasing local market share. Stable legal framework. Stable political situation. | Lower labour costs. Stable social situation. | Inflation. Tax system and social contributions. Bureaucracy. | Analyses firms by category: non-exporters, re-exporters, and exporters. |
| Lankes and Venables (1996) | Various CEE/FSU | 117 | Distributors - access to local market. Local suppliers - access to local market. Exporters - production costs. | Distributors - access to EU/EEA markets. Local suppliers - access to EU/EEA markets. Exporter - one-time opportunity from transition process. | N/A | Looks at choice of control mode and project function. |

Source: Terri L. Ziacik, ‘Motivational factors behind foreign direct investment in Estonia: a comparison of empirical studies’ Eesti Pank Bulletin No 4 (39), 1998

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