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*Shifting Competitiveness, Evolving MNE Strategies and
EU Enlargement: The Case of Hungary*

– **Yusaf H. Akbar**



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**Shifting Competitiveness, Evolving MNE Strategies
and EU Enlargement: The Case of Hungary**

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Shifting Competitiveness, Evolving MNE Strategies and EU Enlargement: The Case of Hungary

Introduction

As eight countries from Central and East Europe (CEE) joined the EU in May 2004, the role played by MNEs and Foreign Direct Investment (FDI) in the economic development of the CEE region continues to be a subject for considerable debate.

Originally attracted by low cost locations, relatively well-educated workforces and the attraction of having virtually tariff-free access to the EU from the CEE region, MNEs poured into the region (Estrin *et al.* 1997, 2000). Further attracted by privatization programs of the post-socialist governments, MNEs had the opportunity to acquire and restructure companies across all sectors of the economy (Meyer 2000, Pavlinek 2002a, Zlochy-Christy 1995). Moreover, Greenfield investment took place on a broad scale across the region as MNEs set up production facilities for goods to be sold regionally and shipped back to the EU (Akbar and McBride 2004).

In recent years and as full accession to the EU arrives, there is evidence to suggest that the prospects for FDI in countries in the CEE region are changing. This is for several reasons. First, the privatization pool available to MNEs has dried up since most of the Accession-8¹ has sold their state-owned enterprises. Second, the relative cost-advantage presented by these countries has been eroded as salaries of workers, cost of capital and real estate have risen in line with increased aggregate demand and the improvement of their macroeconomies. Cities such as Prague and Budapest now have cost of living being roughly equivalent to neighboring cities such as Vienna.² Third, EU membership implies enhanced regulatory controls that are beginning to increase costs to companies if they are to comply with new regulations required by EU membership. Fourth, to a limited degree, freedom of movement of persons within the EU will allow many citizens from the Accession-8 to find higher paid work in the existing member states thus reducing the pool of skilled labor available in the CEE region.

These developments pose questions for the FDI strategies of the MNEs already located in the CEE region. The main objective therefore of this research is to consider how and in what ways, the FDI strategies of the MNEs are evolving and are likely to be changed by the above shifts in CEE competitiveness.

In terms of the theoretical literature on MNEs and FDI, the paper draws on the work of authors such as Dunning, Rugman, Verbeke and others who have all tried to develop our understanding of the MNE and FDI and how business strategies determine

¹ The Accession-8 are Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia

² Interview with Rainer Silhavy, General Manager, Raffeissen Bank.

the incidence and location of FDI flows. The work also draws on empirical research (e.g. Akbar 2003, Akbar and McBride 2004) which examines the impact of FDI on economic development in the CEE region as well as EU enlargement.

The MNE/FDI literature identifies two main kinds of motives for investment in CEE. First, efficiency-seeking FDI attracts MNEs to the CEE region in pursuit of relatively high-skilled but lower cost labor compared to West Europe, North America or Japan. However, as relative labor costs rise, MNE may consider seeking out lower-cost alternative locations for production if the rising labor cost reduces their competitiveness. Second, MNE's invest abroad for market-serving purposes: as incomes rise in economies, MNEs are tempted to remain since they can now access growing income markets for their goods and services. Nevertheless, MNEs may regard countries as being central to an overall value-chain configuration which generates greater efficiency and synergy. In this sense, while relative labor costs may not be the main efficiency enhancing property of a given location, spatial proximity to core markets may lead to logistics efficiency. Moreover, countries may be important locations for industrial clustering. Again, while the relative cost of labor may not be low, the specific knowledge embedded in these clusters can serve as an attractive asset for MNEs. Examples of this are links between universities and company R&D. MNEs can regard investment in 'strategic' sectors in a given region as important. Specifically, first-mover advantages can lead MNEs to invest and to re-invest in order to maintain their strategic leadership. MNEs respond to public policy and regulation in their FDI strategies. If governments offer attractive conditions for FDI through subsidy and tax incentives, this can lead to FDI flows being attracted toward this regulatory-friendly FDI environment.

Through an empirical examination of strategies of MNEs in Hungary, this paper examines these motives for FDI in Hungary in the light of shifting competitiveness of the Hungarian economy. The paper makes use of two empirical sources. First, the paper uses macro secondary data on FDI flows and macroeconomic data in order to build a general picture of FDI in Hungary. Sources of such data include American Chamber of Commerce; Budapest Business Journal; EU Commission and Hungarian International Trade Council. Second, we undertake detailed open interviews with MNE managers and public policymakers in Hungary across a range of sectors in order to develop the specific strategic insights relating competitiveness to MNE strategy.

The principle findings of the research are as follows. First, that Hungarian competitiveness is indeed shifting away from the traditional low-labor cost that underpinned much of the early FDI in the country. Second, important changes in the public policy environment in the field of taxation have had an important influence on both new FDI and reinvestment in Hungary when MNEs have had the choice to invest in several locations with similar factor-conditions. Third, Hungary's relatively skilled labor pool in the information technology and engineering sector is beginning to emerge as a nascent technology cluster based around close cooperation between Hungary's technical universities and MNEs who have already committed resources to the country. Fourth, the Hungarian government's ability to offer FDI-friendly regulations is becoming increasingly constrained within the context of its EU membership. Fifth, some MNEs are

beginning to focus their FDI strategies on a regional rather than country-based lens. Indeed as EU membership has removed barriers to movement across countries within Central Europe, MNEs are no longer focusing solely on national resource endowments but analyzing ways in which they invest across countries to achieve a more cost-efficient configuration of their value chains. In this instance, the Visegrad countries have emerged as regional production locales.

Literature Review

The literature on FDI motivation and its associated impact is quite extensive. This paper does not intend to replicate the previous extensive literature reviews. However, it is important to emphasize some aspects of this literature especially regarding the East and Central Europe (ECE) region. There have been several themes in the ECE literature on FDI. First, the arrival of FDI has been examined in the context of economic transition (Akbar and McBride 2004; Dunning 1993; Economic Commission for Europe 2001; Estrin et al. 1997, 2000; Fabry 2001; Gorzelak 1996; Hunya 2000; Lankes and Stern 1997; Meyer 2000; Pavlinek 2002; Zemplerova 1998 and Zloch-Christy 1995). While views on the nature of the contribution of FDI to the process of economic transition and development vary in this broad literature, all of the literature recognizes that FDI has played a unique and unprecedented role in the process of economic reform and transformation in ECE.

Second, FDI and the issue of technology transfer in ECE has been the focus of considerable research (Bell 1997; Dyker 2001; Gokhberg 1999; Kinoshita 2001; Knell and Hanzl 1999; Radosevic 1999; Sharp and Barz 1997; Smarzynska 2003). One of the main controversies of the role of FDI on a domestic economy has been the role of R&D spillover and technology transfer. In particular the issue as to whether MNEs actually transform the technology base of recipient countries has been central to this controversy. Scholars have highlighted the link between company level value-added, economic growth and R&D activity (Bayoumi et al 1999; Barrell and Pain 1997; Blomström and Sjöholm 1999; Coe and Helpman 1995; Ethier and Markusen 1991; Pack and Saggi 1997). It is argued that while a considerable amount of R&D activity takes place in the home countries of MNEs, theoretically MNE activity in the host country leads to R&D spillover through essentially two channels. First, supplier links with local companies can enable local firms to learn and adopt new technologies. Second, through the consumption of MNE products and services in the host country, consumers can drive demand for product development by local companies who compete with the MNEs. The empirical literature on ECE provides inconclusive evidence on the R&D spillovers and technology transfer benefits of MNEs. Among other explanations, the effects are sensitive to the sector examined and the degree of integration between the value-chains of MNEs and the local economy. For example, where MNEs based in ECE seek out local suppliers and integrate them into the value-chain, then the learning effects are important. Moreover if MNEs locate because they wish to access specific knowledge e.g. Ericsson in Hungary, then the ability of MNEs to transform local scientific knowledge into valuable applications can be significant.

Third, the relationship between FDI and productivity (and competitiveness) in ECE has been examined in some detail (Djankov and Hoekman 2000; Hunya 2000b; Konings 2001; Mišun and Tomšik 2002; Szanyi 2000; Tupy 2003). One of the main challenges facing the transition economies in 1989 and in the years after was the need to replace the capital stock inherited from the centrally planned economies. Since domestic capital investment capacity was low, FDI provided an opportunity for ECE economies to replace the capital stock. Furthermore, one of the major weaknesses in the ECE economies at the start of the 1990s was the incredibly poor factor productivity (especially labor productivity). Arguably, FDI generated employment would raise factor productivity because of combining new capital with the relatively skilled (but low-cost) labor forces in ECE. Again, the evidence in the ECE tends to demonstrate that this is the case. It is important to note however, that it was inevitable that factor productivity would rise compared to the centrally planned era. A broader issue examined in the literature, especially that associated with the competitiveness literature is about the global position of ECE countries. Thus the question is whether ECE countries have been able to maintain their competitiveness in comparison to other emerging economies such as China and India. In this instance, the evidence is mixed and interestingly one of the issues raised in the literature is the impact of EU membership on ECE competitiveness. Since the regulatory burden embedded in the *acquis communautaire* implies greater regulations on industry compared to the transition period, this could reduce the competitiveness of the ECE economies compared to their global rivals.

Fourth, taking a step away from mainstream economics and international business approaches, the economic geography literature has examined the role of FDI and MNE activity in the ECE region. Their principle focus has been on the spatial location of activity and its implications for economic growth (Blažek 1999; Dománski 1999; Hamar 1999; Hardy 1998; Michalak 1993; Smith and Ferenčíková (1998); Young et al. 1994). These scholars largely take the view that if left to itself, the spatial allocation of FDI in the ECE region would exacerbate rather than reduce regional and social disparities. This is because MNEs respond to existing agglomerations or poles of economic activity. Thus in the ECE region, most MNEs who have invested in the region chose the capital city and the regions close to the capital city as the place to invest. This exacerbates the already existing income and social disparities between the capital and the ‘countryside’ in these countries. Also, FDI flows have tended to cluster in areas close to the EU borders of the ECE region. The policymaking implication of this research is that governments may need to adopt pro-active regional development strategies to reduce disparities. This is an issue which we examine when we consider the Hungarian government’s response to the clustering of FDI in the Budapest region and around the Budapest-Győr-Sopron region.³

Lastly, the link between FDI and EU Enlargement in ECE has been considered (Akbar 2003; Dyker 2001; Domanski 2001; Tupy 2003). The literature highlights several related aspects of the impact of EU enlargement. First, EU membership implies greater competition for ECE companies. While Hungarian companies have got used to foreign competition in the years prior to EU accession, it is nevertheless argued that existing

³ The Hungarian Automotive Parts Cluster (*Pannon Autoipari Klaszter*) PANAC is an example of this clustering in the Budapest- Győr-Sopron region.

competition will intensify in Hungary as well as other member states in the ECE. Previous enlargements to include Spain and Portugal demonstrate clearly that competition continued to intensify in product and service markets a long time after these countries had joined the EU. Second, EU membership should increase the constraints on the government's incentives programs to attract FDI because of the need to adopt EU competition disciplines on State Aid. Third, MNEs based in the accession countries will continue to leverage higher product and service standards in the ECE member states as a means of winning the competition with their local rivals in these markets.

FDI, MNE activity and Hungary at Accession

The following section offers a survey of the current position of FDI and MNE presence in Hungary. Through the use of descriptive data, this section illustrates the continuing profound nature of MNE involvement in Hungary. The aim of this section is furthermore to illustrate the development of FDI in Hungary in the past decade and to show, *inter alia*, its position in the FDI 'race' with states in the CEE region such as Slovakia, Slovenia Romania and the Czech Republic.

Macroeconomic and FDI data

Table 1 illustrates the general macroeconomic situation and forecast in Hungary from 2004-7. Of note in this table are Hungary's steady GDP growth rate; its low unemployment rate and its declining inflation rate.

While Hungary continues to maintain a trade and current account deficit, this is due in large part to the role played by MNEs who import intermediate products for assembly and/or further elaboration in Hungary. An example of this is Audi Hungaria's engine plant in Győr.

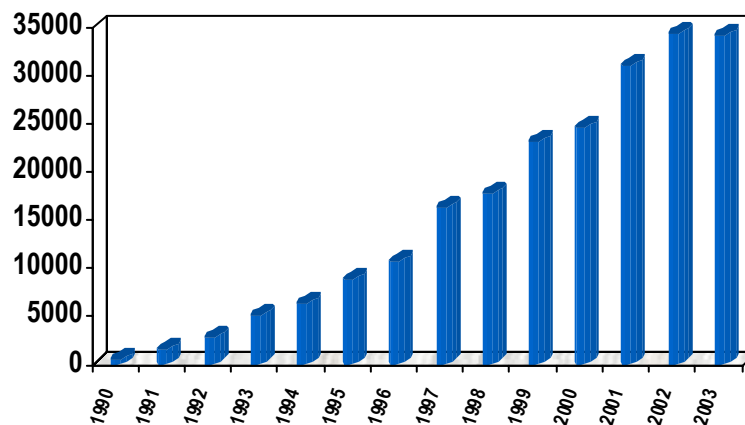
Table 1 – Macroeconomic Forecast for Hungary

	2004	2005	2006	2007
Gross domestic product (% growth)	3.3	3.8	3.8	4.1
Industrial production (% growth)	7.1	7.8	-	-
Total Exports (billion USD)	49.8	54.3	-	-
Total Imports (billion USD)	53.5	57.8	-	-
Consumer prices (% annual change)	6.6	5.3	4.2	3.7
Balance of foreign trade (billion USD)	-3.7	-3.5	-	-
Current account balance (billion USD)	-4.9	-4.4	-4.8	-4.3
Unemployment rate (% of labour force)	6.2	5.6	5.5	5.3

Source: ITD Hungary and Business Monitor International, “Consensus Forecasts for Eastern and Central Europe”, June 15th 2004.

Figure 1 below shows the evolution of Hungary’s FDI stock over time. As can be readily noted from the diagram, Hungary has built up a considerable stock of FDI. Of note in this figure has been two periods of substantial growth in FDI – in 1996-7 and 2001-2. Also, Hungary has experienced a leveling off of the FDI stock in 2003. The explanation for this comes from the two sources. First, some MNEs have withdrawn their FDI from Hungary such as IBM who moved its hard disk drive plant from Hungary to China and also Flextronics who moved their production of Microsoft Xbox game consoles.⁴ Figures 2 and 3 break out this effect in more detail. As can be noted from figure 2, the important change has been the sharp fall in inward FDI in 2003 compared to 2002 combined with a small amount of FDI outflow. Figure 3 further amplifies this effect. The clear downward trend of net FDI at the end of 2002 and into the first quarter of 2003 illustrates the leveling off of the FDI stock in Figure 1. In a later section, the causes for this FDI decline will be examined.

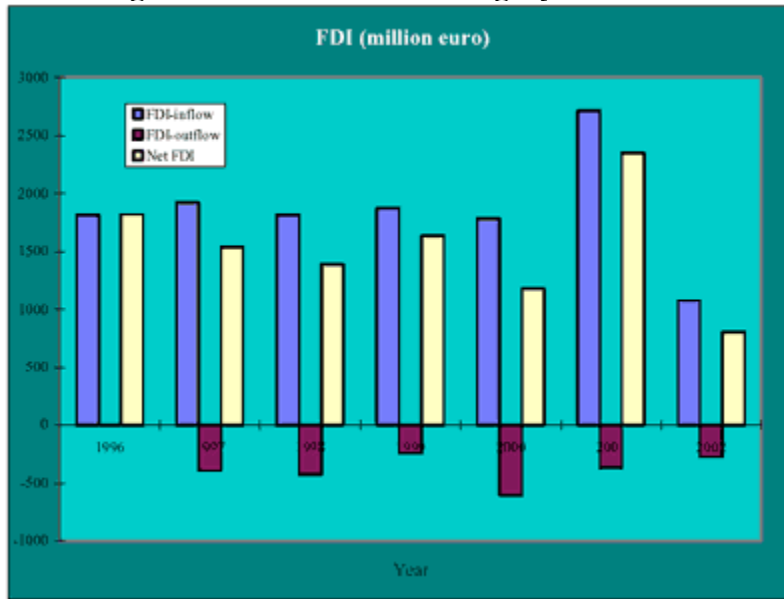
Figure 1 – Development of FDI Stock in Hungary 1990-2003



Source: ITD Hungary and *Magyar Nemzeti Bank* (National Bank of Hungary). Figures include reinvested earnings from 1995

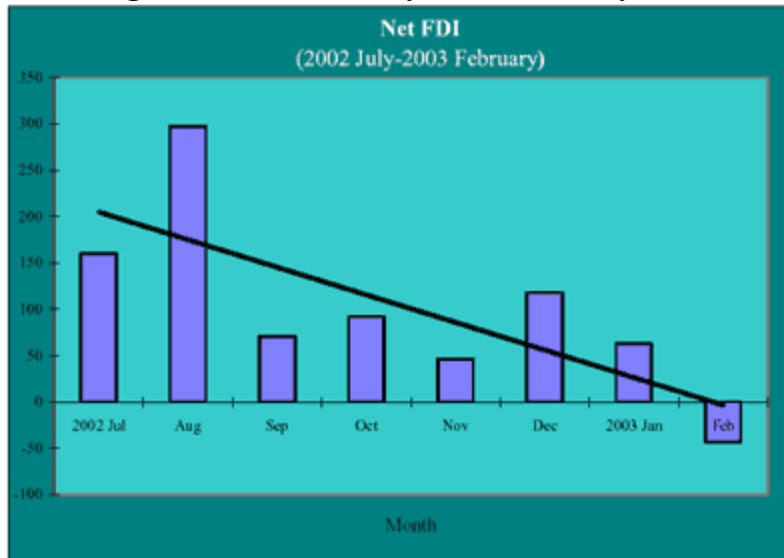
⁴ “Hungary Falls Behind in FDI Race” *Budapest Business Journal*, Vol. 10 No. 28, June 17-23, 2002.

Figure 2 – FDI Flows in Hungary 1996-2002



Source: Data adapted from Hungarian Central Statistical Office sources

Figure 3 – Net FDI July 2002-February 2003



Source: Adapted from Hungarian Central Statistical Office sources

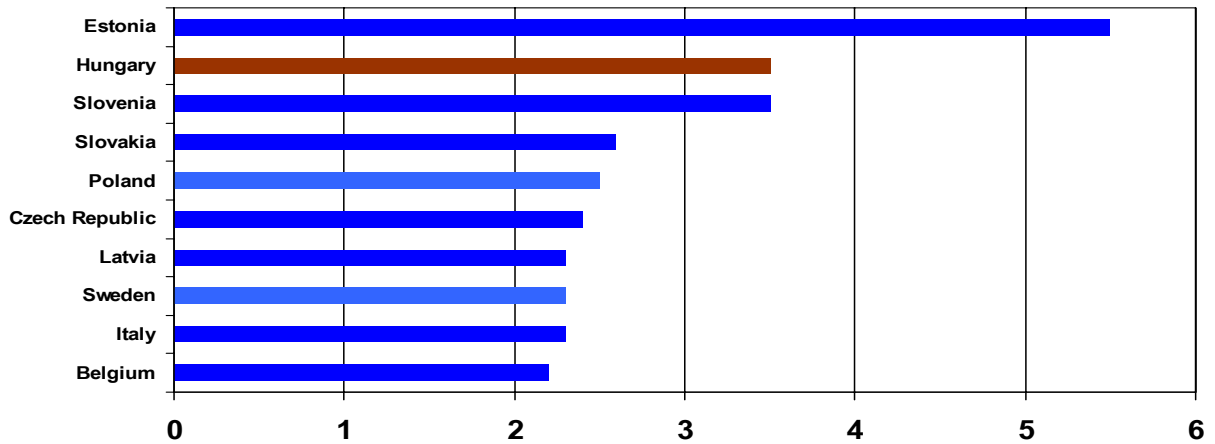
Source of Competitiveness – International Comparisons

As discussed in the literature review, one of the issues facing ECE economies is their relative competitiveness vis-à-vis other countries elsewhere in the world. IMD Lausanne’s World Competitiveness Yearbook provides some interesting yardsticks for competitiveness comparisons in the following figures. Overall, Hungary ranks 37th from 102 countries surveyed in the annual report. Importantly, it ranks above the Czech

Republic (38th), Slovakia (42nd) and Poland (44th). It is behind Estonia (27th) Slovenia (31st) and Latvia (34th).

In figure 4, the relative transparency of tax regulations is given (*get definition from IMD*). As can be seen, in an ECE and broader European context, Hungary ranks second behind Estonia in 2003-4 and equal to Slovenia. The scale is from 1 to 7 with the latter being the most transparent.

Figure 4 – Transparency of Tax Regulations 2002-3

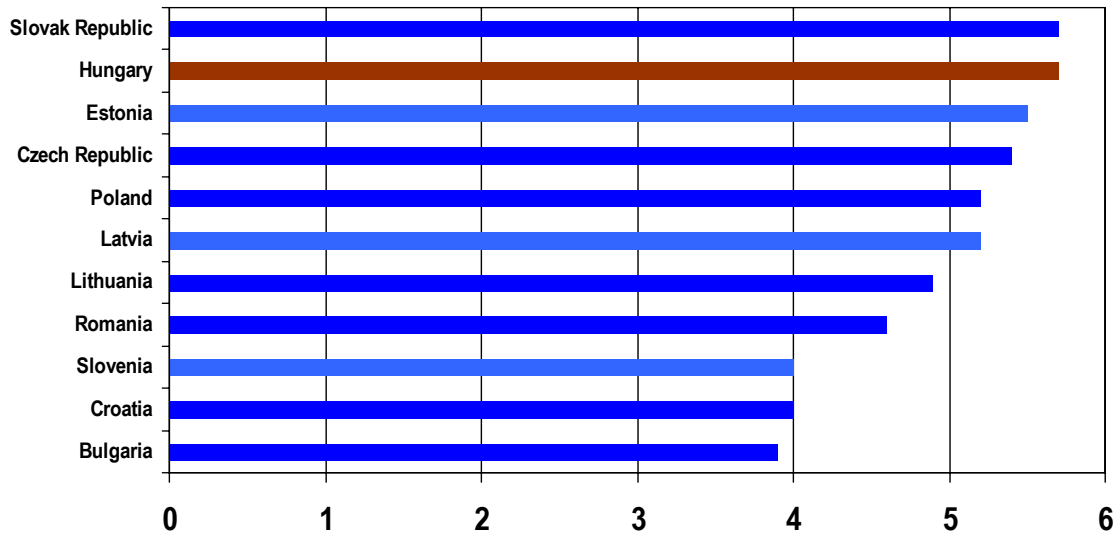


Source: World Competitiveness Report 2002-3.

Figure 5 illustrates comparative efficiency of legal systems across Europe. Using the same scale, Hungary ranks above a group of ECE countries but less transparent when compared to Finland. Figure 6 shows foreign ownership regulations and their degree of openness. On a scale of 1 to 7, a score of 7 represents a situation in which foreign ownership is prevalent and encouraged. Unsurprisingly, Hungary ranks first alongside Slovakia in 2003-4. As will be discussed in section X below, Slovakia’s rise to the first place in this regard is in part due to the Slovak government’s learning from Hungary’s experience.

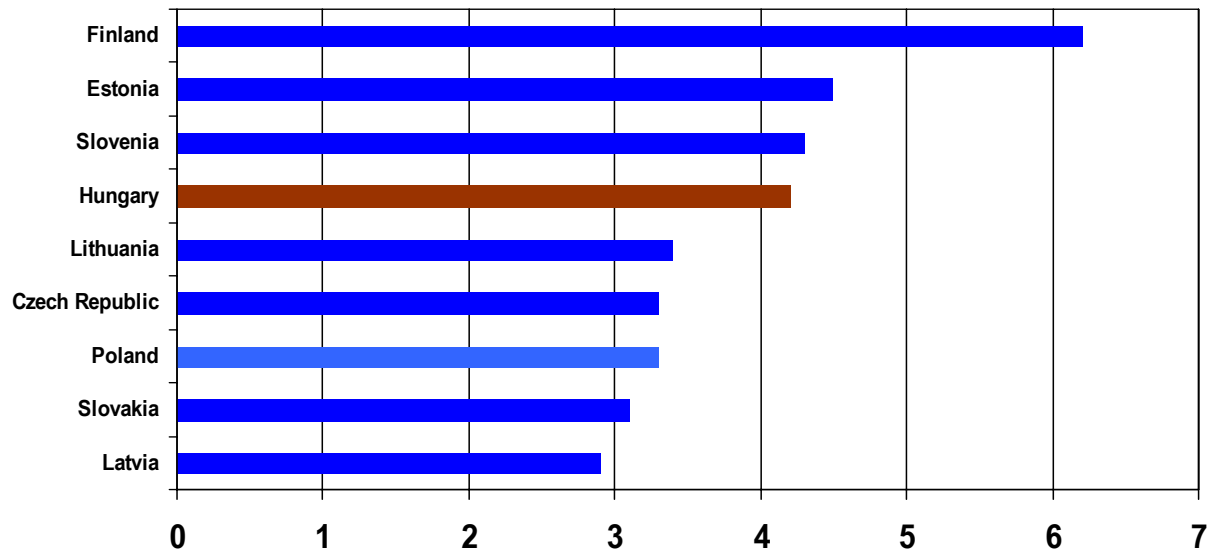
If we examine the quality of the science base of countries in the region in Figure 7 below, Hungary ranks first. This is a measure of the degree to which R&D activity could be enhanced by the presence of primary research activity and the spillover linkages between the two.

Figure 6 – Foreign Ownership Regulations



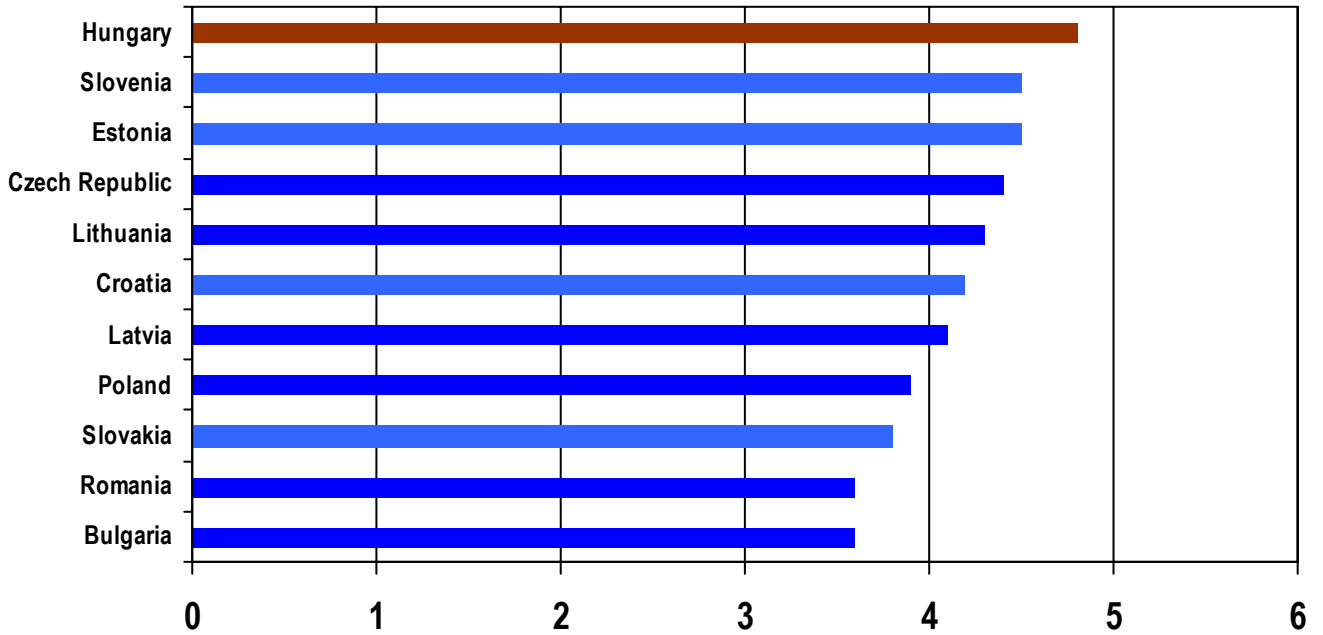
Source: World Competitiveness Report 2003-4.

Figure 5 – Efficiency of Legal Environment



Source: World Competitiveness Report 2003-4.

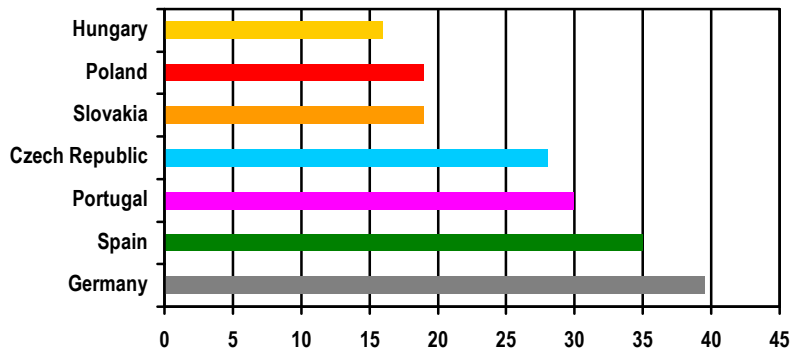
Figure 7 – Quality of Scientific Research Institutions



Source: World Competitiveness Report 2003-4.

Figure 8 shows corporate tax rates across the region. Again Hungary has the lowest tax rate for companies. Of note is Slovakia in second place who has introduced a ‘flat tax’ rate for both corporate, income and sales tax. This is significantly different from Hungary’s income and sales tax rates. Hungary’s sales tax is either 12.5 or 25 percent and its income tax can be as high as 50 percent of income. Compared to Germany, all economies in ECE have lower corporate tax rates.

Figure 8 – Corporate Tax Rates (as a percentage) 2003



Source: Economist Intelligence Unit.

Figure 9– Corporate Tax Rate Changes (Percentages) 2003-4 of selected countries

Country	2003	2004
Germany	39.6	38.7
France	34.3	35.4
Netherlands	34.5	34.5
UK	30.0	30.0
Austria	34.0	25.0
Sweden	28.0	28.0
Ireland	16.0	12.5
Poland	25.0	19.0
Slovakia	25.0	19.0
Hungary	18.0	16.0

Source: OECD

Figure 9 above demonstrates the continuing lower corporate tax rates available in Central Europe compared to other EU member states. It is unlikely that Central European EU members are likely to raise their corporate tax rates in the near future, contrasting dramatically with west European EU member states' tax rates.

Micro-level and Strategic Data

We provided a section above that offered an overview of the macroeconomic trends in Hungary and the nature of FDI activity, various measures of competitiveness and how conceptually they may be related. In the FDI motivations literature, we identified several criteria to help frame our discussion such as labor costs, productivity measures, public policy issues and EU enlargement. On the macroeconomic level, there has been considerable discussion of these criteria and how they impact FDI and MNE strategies.

The aim of this section, through detailed interviews and consultations with MNE managers and public policymakers based in Hungary, is to examine whether these macroeconomic trends are corroborated at the firm-level. In our paper we aimed to interview managers across a range of sectors from manufacturing, assembly, services and network industries. The methodological aim was to offer a broad enough set of industries on a qualitative basis to build up as detailed an empirical setting as possible. While econometric, quantitative methods provide very important and information-rich material, they arguably suffer from the necessary level of abstraction required (and the key assumptions of normality of data distribution) to generate systematic data outcomes. Thus we argue that while our qualitative approach can in no way fully replace the methodological and empirical strengths of quantitative, regression-based analyses, we believe that qualitative interview methods can provide scholars with important insights into the thinking and actions of managers which quantitative methods cannot always provide us.⁵

⁵ *Nostra culpa*: we are still carrying out interviews for this research as this first draft of this paper is being drawn up. Later versions of this paper will include more qualitative, empirical material.

In our interviews we were aiming to generate qualitative responses to the following topics and issues. Aside from the basic data on company size, sector of activity etc., we were interested in the following. First, what were the original motivations for FDI in Hungary of the companies we examined? The aim of this was to ascertain whether the FDI fitted into resource-seeking, market-serving, strategic-asset seeking or other FDI motivations. It also served as the starting point for us to understand the changes in strategy (if any) that the MNE was pursuing. Second, we sought information on the level of MNE corporate commitment to the FDI project. The aim of this question was to gauge the MNEs time-horizon for its investment. For example, we were interested in examining whether the MNE concerned had developed a strategy beyond resource-seeking if that was its initial aim of FDI. Third, we asked questions related to local and other MNE competitors and whether they played a role in the FDI strategy of the foreign company. These questions were aimed at examining the extent to which competitive forces impacted the strategic aspects of the FDI project. Thus for example, did the MNE concerned alter its level of FDI commitment in the light of new entry of other MNEs or increased competition of local companies?

Fourth, how did the MNEs consider Hungary's competitiveness was affecting their strategies in Hungary? Of particular interest for our research was to examine whether rising labor costs in Hungary were affecting the FDI strategies of MNEs based there. Moreover, did the MNE consider other alternatives for investment in neighboring countries or elsewhere in the world? Fifth, we sought managers' views on how EU membership had impacted their FDI strategy and whether EU membership in Hungary had changed the way they considered their investment and production strategies in Hungary. In the following section, we highlight some of the key issues raised through the interviews.

(i) Public Policy

The most common observation about Hungarian competitiveness among the managers and policymakers we interviewed was the role played by public policy in several areas in the 1990s. First, in many respects, by taking the lead in privatization in the region through sales to strategic foreign investors, Hungarian policymakers offered one of the most attractive environments into which MNEs could enter the Central European economy. While the reasons for sales to foreigners were motivated to a significant degree by macroeconomic pressures, the outcome was to allow Hungary to emerge as the leading FDI recipient country for several years after 1989.⁶ Once the privatization pool had dried up, Hungarian inward-FDI slowed substantially.⁷ New areas for privatization and acquisition appear to be in the agricultural sector despite the politically sensitive nature of arable land ownership in Hungary.⁸

⁶ Interview with Csaba Kilian, Investment Director, ITD Hungary, Budapest, June 2004.

⁷ Op. cit. 3

⁸ Interview with Dr. Ivan Gara, Managing Director, Raiffeissen Bank Hungary, July 2004.

Second, Hungary's tax regime for many years had offered foreign investors an attractive fiscal environment.⁹ All of the companies we interviewed who had entered Hungary on the basis of the tax holiday had fully utilized the opportunity to reinvest significant amounts of profits back into the Hungarian subsidiary. Third, Hungarian efforts to join the EU and especially successive government efforts to implement the *acquis communautaire* prior to accession had played an important role in allowing companies to operate in an EU-compliant regulatory environment whilst still benefiting from the relatively low-cost factor environment. An excellent illustration of this point is the financial services sector where the Hungarian government had already de-regulated the sector several years prior to EU accession. In this sense, this makes the Hungarian financial services sector one of the most competitive in the region.¹⁰

Another issue for Hungarian public policy raised in the interviews was how neighboring countries such as Slovakia and Czech Republic¹¹ were adapting their public policy to become more competitive than Hungary. In many senses, Hungary was an 'exemplar' for public policy towards FDI. Nevertheless senior Hungarian public policymakers recognize that they have lost ground to neighboring countries in this regard.¹²

On the other hand, senior managers at one of the world's leading internet telephone companies headquartered in Budapest expressed concern at the continuing micro-level bureaucracy that companies face in Hungary. The length of time it takes to incorporate a company in Hungary for example takes considerably longer than in Western Europe and North America. Additionally, filing papers for residency permits continue to cause problems with hiring non-Hungarians to work in Budapest.¹³

(ii) Factor Cost Competitiveness

Throughout our interviews, managers emphasized the continuing factor cost competitiveness that the Hungarian economy has compared to rivals in Western Europe and within Central Europe.

Obviously, wage costs in Hungary remain low compared to EU averages. More importantly, it is the relatively high level of skills in the workforce combined with low wages that remain one of the key sources of competitiveness for the Hungarian economy. Close linkages between the Technical University of Budapest and foreign companies has

⁹ Interview with Robert Gray, Managing Director, Caterpillar Hungary Ltd, July 2004.

¹⁰ Op. Cit. 7

¹¹ The Czech Republic copied Hungary's tax incentives in 1999. Slovakia introduced a 'flat tax' for companies.

¹² A point made by Csaba Kilian. He expressed the view that the Hungarian government has become aware of this loss of public policy competitiveness and that they will need to reconsider current approaches.

¹³ Interview with Paul Cheng, Founder and CEO, Ayslum Telecom, Budapest July 2004.

also facilitated the continued success of Hungary's skilled pool of scientists and engineers.¹⁴

However, at the level of low- to mid-skilled workers, Hungary's cost competitiveness is threatened by its neighbors and distant competitors in Asia.¹⁵ This is driven, to a significant degree by labor shortages that have developed as a result of the low labor mobility among low-skilled workers in the Eastern counties of Hungary.¹⁶ While the labor market remains tight in the Budapest region and Western counties, the lack of labor mobility means that companies have to provide buses to ferry workers between their home and the factories.¹⁷ Given the relative ease with which some productive capital could be moved to neighboring Slovakia, this is a cause of concern for the Hungarian economy. Evidence of this shift towards its neighbors comes from Peugeot's and Hyundai's decision to locate in Slovakia and Toyota's to locate in the Czech Republic.

Despite this concern, MNEs continue to expand their activities in Hungary. General Electric has expanded its activities beyond light bulbs¹⁸ to include manufacture of turbines, medical services equipment; the development of an R&D center for medical equipment research as well as an IT services center.¹⁹ Siemens employs over four thousand workers in a cable factory. It was only until the end of July 2004 that Siemens decided not to move its mobile phone manufacturing to Hungary after German labor unions agreed to substantially increase working hours and lower non-wage based salary benefits for its workers.

One of the surprising findings from the interviews was that Hungary's financial services sector is one of the most competitive in the region. As an illustration of this, OTP, Hungary's largest retail bank has begun to make acquisitions elsewhere in the region, normally a sign of the financial health of a company. A senior banker working for a major Austrian bank suggested that Hungary's capital market structure makes it more attractive than some other West European markets.²⁰ This is largely due to the process of

¹⁴ Ericsson's decision to locate its R&D headquarters in Budapest is a reflection of this.

¹⁵ Robert Gray, Managing Director, Caterpillar Hungary emphasized the continuing struggle he faces to keep costs down given the relatively unskilled work involved in his company.

¹⁶ A point emphasized by Csaba Kilian. In an earlier article, Akbar and McBride (2004) highlighted the weaknesses in the Hungarian mortgage market as a barrier to labor mobility. Recent evidence suggests that the development of mortgage market has reduced some of these problems for skilled workers who represent a relatively low credit risk for the retail banks.

¹⁷ For Caterpillar, this means a 90 minute commute everyday for some of its workers, observed Robert Gray, Managing Director of Caterpillar Hungary.

¹⁸ GE acquired Hungarian light bulb manufacturer Tungsram in the early 1990s.

¹⁹ Interview with Csaba Kilian, ITD Hungary.

²⁰ Comment made by Dr. Ivan Gara, Managing Director, Raiffeisen Bank.

consolidation in the sector that occurred in the mid-90s as local banks were acquired by foreign banks and some foreign banks that entered the market initially left.²¹

Returning to the issue of skilled labor cost competitiveness; Hungary is developing as a base for MNE ‘backroom’ activities and outsourced service provision. The explanation for this can be found in the relatively technology capable; financially-skilled and linguistically trained work force combined with a surplus of low-cost, high quality office space.²² There are several examples of significant MNE investment in these kinds of activities. Exxon-Mobil has moved its internal financial audit and accounting services to Budapest. Diageo, Avis and ING insurance have also moved their administrative offices to the capital of Hungary. In the case of Diageo, they made approximately 70 percent cost savings compared to their previous locations across Europe.²³ EDS/Accenture bases its outsourcing services in Hungary intensifying a trend towards outsourcing location in Hungary. Further examples of outsourcing, in manufacturing, are Flextronics and JBill’s outsourcing activities in Hungary.²⁴

(iii) EU Accession

Previous experience with EU accession in other countries such as Spain, Portugal and Greece suggested that EU accession while offering significant market access opportunities for companies based in these countries, the increased regulatory burden of EU membership on companies led to increased costs and lower competitiveness. Given the history of political and economic transition in ECE, the anticipated burden of EU accession on the ability to effectively implement the *acquis* could have reduced the competitiveness of Hungary. Unanimously, managers interviewed for our research underplayed the role and importance of EU accession on Hungary’s competitiveness. This could be explained in two ways. First, Hungary’s rapid adoption of many of the central obligations of EU membership such as trade and capital market liberalization early in the process of joining the EU meant that MNEs were already operating in an EU-compliant environment. Second, as Akbar (2003) demonstrates, MNEs themselves leverage EU regulatory standards as competitive strategy against local companies. They combine low local factor cost with higher quality process and product standards that they bring from their operations in the EU. In some sectors such as financial services, this effect was especially important and the significant foreign ownership of the banking intensified this.

²¹ Examples of these were Rabobank, ING Bank and most famously ABN-Amro who sold their operations to K&H bank.

²² Op. cit. 17.

²³ Ibid.

²⁴ Interview with Don Polson, Managing Director, JBill Central Europe, July 2004.

(iv) Emerging cross-border regional competitiveness

One of the most important effects of EU market integration has been the development of inter-regional economic development. This has been a response both to the removal of national barriers to trade but also because of explicit EU-regional cooperation. While it has been pointed out in our research that the re-emergence of economic cooperation in Central Europe can be seen as a Hapsburgian *retour-en-arrière*, this integration is a natural consequence of market integration. The automotive sector is an excellent illustration of this. In a small zone of around 400 km, several of the world's leading automotive assemblers have located production. The removal or easing of border controls has allowed MNEs to tap a regional labor market with companies bringing workers across national borders to work at their assembly facilities.²⁵ This development mimics similar phenomena in the Liège-Maastricht-Aachen triangle. Workers freely and willingly live and work in different countries, responding to labor market opportunities despite the linguistic differences where three different languages exist.

Future FDI Trends and Hungarian Competitiveness

Given the analysis of events above, the next phase of our research was to enquire as to the future trends for competitiveness and FDI in Hungary. In all of our interviews, we asked managers what they saw to be the future trends for Hungary. The following section is an interpretation and analysis of their observations and views.

Several themes emerged when we examined future trends. First, it is obvious that the dramatic rate of FDI growth in the decade after 1992 was likely to slow down since the privatization pool has essentially dried up. Second, future new inward FDI would be focused largely on sectors hitherto underdeveloped such as tourism and agriculture.²⁶ Third, as manufacturing costs rise, due in large part to rising wage costs and limits to productivity growth, inward-FDI was likely to shift towards the service sector in Hungary. In particular Hungary's geographic location as a gateway between West and East Europe places it in an extremely favorable position to act as a logistics hub for transportation companies.²⁷ Fourth, the concept of national competitiveness in the context of EU accession for small economies in Central Europe may become redundant. This is largely because of interdependence of their economies and their associated economic fortunes. Thus rather than pursue beggar-thy-neighbor public policies to attract inward-FDI from each other, competitiveness could rely upon interdependencies between the countries and coordinated policies in the areas of labor and capital market regulation; regional development and fiscal regimes.

²⁵ This is the so-called "frontalier" phenomenon.

²⁶ Emphasized by both Csaba Kilian and Dr. Ivan Gara.

²⁷ Interview with Keve Papp, Director of Operations, Asylum Telecom.

Conclusions and Implications of Research

Our research has examined the complex and multifaceted relationship between inward-FDI, MNE strategies and competitiveness in Hungary. Once the leading country in the ECE region in terms of per capita inward-FDI, Hungary carved out a position as one of Europe's most attractive locations for MNEs. This can be accounted for due to a combination of its tax efficient fiscal regime, a technically well-educated workforce, favorable geographic location at the crossroads between western and eastern regions of Europe and its first-mover decision on privatization. As Hungary joins the EU, it has become clear that a number of these advantages have been eroded by neighboring countries or disappeared.

From the interviews conducted for this research, Hungary's position as one of the most attractive locations for FDI is likely to remain strong for the near term. It continues to attract new investment and importantly, it has been successful in persuading MNEs based there to reinvest in existing activities or to expand into new activities. While most managers expressed concern about rising labor costs, none of them believed that it would be the determining factor in their companies' decision as to whether they stay or move elsewhere. Of importance though is how the fiscal regime will become less important as a new emphasis on regional development will begin to offer incentives to MNEs.²⁸

What are the implications for research into FDI and competitiveness of our study? First, Hungary's experience illustrates a well established theory concerning how countries move through successive phases of economic development. Hungary has begun to leverage increasingly the skilled aspects of its labor force and on its spatial and geographical advantages rather than on marginal labor costs as it may have done initially. Moreover, as the level of economic development has risen in Hungary, the importance of service industries both in terms of serving the local market but also as location for service provisions activities for the regional or European market has increased. This is illustrated by the development of a mortgage market as well as the growth of back-office and outsourcing services in Hungary. Second, our study highlights the primordial role played by public policy in shaping competitiveness. Poor public policy can lead to loss of competitiveness and FDI flows. Continuing micro-level bureaucracy can cause problems for subsidiaries. While this effect may be difficult to measure on a macro-level, on a tactical and operational level, it can lead to significant inefficiencies.²⁹ On the other hand, appropriate public policy can lead to significant gains for a country's attempts to attract inward-FDI. Anecdotal evidence from this research shows there is a relationship between lower corporate tax rates and inward-FDI. MNEs respond to lower taxes. The FDI experience of Ireland, Hungary and now Slovakia continues to support this claim.

²⁸ We intend to expand our interviews for this research as later drafts of this paper develop. This will allow our study to reinforce our empirical findings.

²⁹ From the perspective of quantitative research, it is a challenge to quantify this effect. A corollary of this kind of bureaucracy effect on operations is 'X-inefficiency' observed in large organizations.

Third, EU accession effects are likely to be less pronounced than initially thought. This is because much of the regulatory transformation that EU accession implies has already been undertaken by the Hungarian government and society. Rather, we should expect that the positive market increasing effects of accession are likely to enhance economic performance in Hungary. Hungary's emergence as a logistics hub may illustrate this *entrepôt* effect.

Fourth, the role of inter-country, regional competitiveness should become an increasing focus of research for international business. This implies a convergence of the economic geography and international business literatures. Small open economies, faced with the complex strategic reach of MNEs, become involved in the process of cross-border economic linkages, wittingly or unwittingly. Understanding how MNE strategies foster these linkages would be a substantial contribution to our understanding of competitiveness-public policy-strategy research.

We would like to finish this paper on this last point. From a public policy perspective, it is questionable as to whether beggar-thy-neighbor competitiveness policies really work in a small open economy context. While it is well established in the macroeconomic literature that the use of exchange rate policy for competitiveness purposes has clear limits, structural competitiveness policies such as fiscal regimes are also arguably limited in their effectiveness. Specifically in the context of EU membership, there are legal constraints on the ability of governments to offer specific incentives to MNEs. Thus, it actually makes sense to pursue regional development policies that require the cooperation of countries. Most obviously regional cooperation is openly encouraged and financially supported by the EU. Moreover, an open, inter-regional economic landscape is more likely to attract inward-FDI. The key issue therefore remains as to how countries capture the benefits of this inward-FDI in the regional context.

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