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Beyond Manichean economics: foreign direct investment and growth in the transition from socialism

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Abstract

Using case study data from Hungary, this paper explores the developmental impact of foreign direct investment (FDI) in transition economies. A review of the debate on FDI is conducted by exploring the political discourse surrounding this issue in Hungary. The numerous and competitive purported mechanisms linking FDI with either economic growth or stagnation are used to analyze the case studies. This analysis reveals that FDI can take very different forms, with very different economic consequences. On balance, the evidence suggests that foreign direct investment has been very positive for the Hungarian economy. However, there exists the possibility that the current success of foreign owned firms will lead to socially detrimental market concentration or even hinder future growth. © 2002 The Regents of the University of California. Published by Elsevier Science Ltd. All rights reserved.

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Introduction

There is a long-standing research project on the impact of Foreign Direct Investment (FDI) on the developing world. This research has sought to resolve the great debate between Modernization theorists and development economists on the one hand and Dependency and World Systems theorists on the other hand. Resonating as a justification of Cold War foreign policy, Modernization theory viewed FDI as

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an ideal mechanism for the diffusion of capital, markets and knowledge that would lead to development for the newly independent countries of the world. (Lewis, 1948; Rostow, 1960; McClelland, 1964; Apter, 1965). Inspired by Vietnamese resistance to what was viewed as US imperial power, Dependency and World Systems theory viewed FDI as the advanced guard of a neo-colonial economic order that brought increasing poverty to the South and wealth to the North. (Galtung, 1971; Wallerstein, 1974; Frank, 1967; Cardoso and Faletto, 1979; Landsburg, 1979; Borschier and Chase-Dunn, 1985; O'Hearn, 1989).

This tradition has spawned a lively, but seemingly never resolved, debate within social science on the effects of FDI on development. With the collapse of Communism this debate was extended to a wider audience, as area specialists and economists argued about what role FDI should play in the transition from state-socialism to market-capitalism. The old positions were recreated. Modernization theory was revived by the neoliberals in the "Washington Consensus". In this perspective, FDI is seen as a force capable of restructuring the obsolete industrial order of the post-communist countries (see especially Sachs and Lipton, 1990; Sachs, 1991, 1994; Fischer and Gelb, 1991; Blanchard et al., 1993; Aslund, 1995. The neo-colonial position is also recreated by some 'populist', left-Keynsian and marxian economists who claim that FDI leads to predatory behavior that further enriches Western multinationals and impoverishes post-communist economies. (Andor and Summers, 1998; Gowan, 1999; Ellingstad, 1997; Matzner, 1995; p. 74; Okoliscanyi, 1993, p. 29; Ettlie (1993).

Methodology

This article is based on the case study method. Already, some of the most important attempts to come to terms with post-communist society have employed case studies of organizations based on either interviews or ethnographies (Burawoy and Krotov, 1992; Stark, 1996; Burawoy and Verdery, 1999). Simple logic suggests that qualitative methods that seek to understand social relationships and processes are appropriate in societies undergoing massive change, like those found in the post-communist world. As Burawoy and Verdery argue "Aggregate statistics and compendia of decrees and laws tell us little without complementary close descriptions of how people-ranging from farmers to factory workers, from traders to bureaucrats, from managers to welfare clients-are responding to the uncertainties they face" (1999, p. 2).

As valuable as they are, generalizations about the post-communist industrial organization based on a limited numbers of case studies are risky affairs (see Hanley et al., 2000, King, 2001a,b). We know that there are a great variety of types of enterprises in post-communist society (see Stark, 1989; Kozminski, 1993; King, 2001a,b). Proclaiming any single type 'dominant' on the basis of case-study data is therefore rather risky and in need of corroboration with representative survey data or at the very least a large number of case studies. Thus, in contrast to the true ethnographies of factories, in which the sociologist spends several months or longer in a particular site (e.g. Burawoy and Krotov (1992), this study seeks to maximize the number of cases, and thus relies on interviews and other case study material, prominently court records (as used in Stark (1996)) and the local business press. The legal records come from 16 regional court registries, and are an amazingly rich source of data, with complete ownership disclosure, annual and financial reports, and the minutes of the board of directors meetings among other information. Appendix 1 describes the cases and the types of data upon which they are based. While the validity of data obtained from the case study is weaker than data obtained using true ethnographic methods, the generalizability of the findings is greatly expanded because of a simple breadth verses depth trade-off.

Case studies were conducted for 59 firms in Hungary. This included firm level interviews in two research trips in Hungary for nine months in 1995–1996 and two months in 1998, and the collection of data in Hungarian court registries during 1998. Domestic owners had a majority of shares in 26 of these firms, while 22 had majority foreign ownership, six were joint ventures, two were state owned enterprises, and one was a state–private mix.

We will not provide a statistical summary of data from the cases, because they were not selected following a random sampling plan but instead by selecting specific industries as case studies (pharmaceutical, aluminum, clothing, furniture), as well as a random sample of 20 firms from a business register, and subsequent snowball sampling, and finally a non-random over-sample of the largest and most important foreign owned firms (the ten largest in the country).

We use these case studies to develop a typology of the types of foreign direct investment, and each type's overall effect on the Hungarian economy. This of course is not statistical proof either of the distribution of these different types or firms or their purported effect on the economy. No one has the data to conclusively answer these questions yet. Future research with access to adequate firm-level data might well consider our findings to be hypotheses waiting to be tested.

Theories of FDI and development

Most theories produced by Western social scientists relating FDI to development are fairly straightforward. The major mechanisms that directly link FDI and development are: (1) investment and technology transfer; (2) the repatriation of profit (and transfer pricing); and (3) linkages with domestic firms, creating more domestic economic activity.[1] While these mechanisms are clearly central to an analysis of the effects of FDI, they are by no means logically exhaustive. The relationship between FDI and growth might be far more complex. This becomes apparent by looking at the publicly advocated positions on the topic in transition economies. We will look at the debate in Hungary, the country from which the case-studies will be drawn,

[1] There are purported indirect effects as well, such as political instability and inequality, which we will bracket from this analysis for space considerations.

as well as the country with the greatest amount of FDI per capita in the post-communist world (and indeed one of the highest in the world).

The political debate in Hungary

In the Hungarian press of the nineties, there have been two distinct assessments of FDI inflow, as well as vociferous opposition to it from the two ends of the political spectrum. In our analysis we first present the two mainstream views of FDI, then the extremist positions (left as well as right).

The majority opinion is shared by most of the mainstream press and the political parties currently in power. The center-right MDF (Hungarian Democratic Forum)[2], while in power (1990–1994), as well as the ruling coalition in 1994–1998 which consisted of the non-hard-liners from the old Communist party MSzP (Hungarian Socialist Party) and SzDSz (Party of Free Democrats)[3] considers FDI to be unambiguously good for the country. Articles and studies cite: (1) technological spillover; (2) the creation of jobs; (3) the fact that several MNCs export much of their products; (4) the income generated by privatization; and (5) the fact that MNCs quickly integrate Hungary in the world economy, often producing prestigious brand name products in Hungary for the first time ever.

This positive assessment may have been influenced from the early nineties by the value of aggregate FDI inflows, especially on a per capita basis, because this statistic was the only widely quoted economic indicator that consistently ranked Hungary the first amongst ex-socialist countries. Therefore, both the government and the press have hung on to FDI statistics as a ‘true’ indicator of westernization to fight back the nightmare of a Hungary lagging significantly behind the Czech republic and even Poland in the race towards western European ‘normalcy’ and integration.

The other opinion is expressed by Gyorgy Matolcsy, as of December 1999 the Minister of the Economy for the ruling Center-Right Fidesz[4] (Hungarian Civic Party) government. While not rejecting FDI, this perspective remains more critical.

In the parliamentary debate of the 1998 budget, Mihaly Varga of Fidesz put it like this:

> The stock of the FDI that entered Hungary in the last six years exceeds 12-14 billion USD. The scale of new productive plants that have been thus built is significant for Hungary…. Concerning the inflow of FDI, however, it is important to note that …the Hungarian economy is not organically connected with these

[2] The center right party with a sizable extreme right fringe that led the 1990–1994 coalition government. It lost most of its followers and split in opposition and participates in the government as a rather minor partner, 1998.

[3] A classical liberal party with strong social democratic tendencies, SzDSz was formed by the small group of opposition intellectuals under socialism. Junior partner in the governing coalition, 1994–1998.

[4] Formed as the classical liberal party of the youth, from 1994 on it gradually shifted to a rightist-conservative position, even changed its name. Senior partner in the coalition government, 1998.

> new large foreign enterprises: what Hungary provides them with is not much more than space, some infrastructure, and none-too-skilled labor. Besides, the large portion of imported goods in the inputs of these foreign-owned companies is one of the reasons of our negative balance of trade.

The 1998 election program of the MDF, while still approving of FDI in general, stresses that "domestically rooted small and mid-sized companies" should be the mainstay of Hungarian business. Those who argue this position, while not denying that FDI influx can have beneficial effects, list some of the following reasons for their distrust of FDI: (1) FDI creates companies that import most of their parts and thus do not help the balance of trade; (2) FDI creates companies that concentrate on blue-collar, labor-intensive activities, keeping the higher value-added and R&D activities in the home country; (3) much of FDI comes just to secure market share, often even in oligopolistic/monopolistic positions; (4) MNCs will eventually repatriate profits; (5) FDI companies have been slow in helping Hungarian small companies adapt to their requirements and produce parts for them; (6) FDI, though it helps economic growth, makes the increase in Hungarian GDP since 1997 a fragile process, largely depending on a dozen or so MNCs; (7) well-organized MNCs have an enormous lobbying power in Hungary; (8) Greenfield investments usually locate in the developed western and central parts of the country, especially in the capital and along the Austrian border, thereby exacerbating regional inequalities; (9) MNCs disrupt or weaken social/cultural cohesion in Hungary, usually representing a strong Americanizing influence on lifestyles. Shopping malls, fast food, and anti-union attitudes are often mentioned in this context.

The parties in the center differ only in how much they accent the considerations discussed above. The opinion of the communist Worker's Party,[5] on the other hand, is nothing if not clear-cut: they want the re-nationalization of all utilities, military production, food processing and banks from private owners, foreign or domestic. In addition, they state that certain 'strategic sectors' should not be in foreign hands. While the idea of re-nationalization reflects the communist belief in the superiority of state property, the idea that strategic industries should be in domestic, albeit capitalist hands reflects the fear of malevolent foreign interference in Hungarian matters by foreign owners, an argument akin to the extreme right position.

According to the program of the MKDP (Christian Democratic People's Party),[6] a Party that, by 1998, is on the extreme right:

> [Privatization measures by the 1994–1998 government that let foreigners take over Hungarian companies] make the position of Hungarian companies in the competition with foreigners harder. Thus, those measures help disintegrate the

[5] The hard-liners left over, when, in 1989, on the eve of free elections, the majority of the active membership of the governing MSzMP (Hungarian Socialist Workers' Party) seceded to form MSzP.

[6] This party participated in the government thanks to the votes of the traditionalist, religious population between 1990 and 1994, in opposition it shifted towards the extreme right and some of its leadership joined Fidesz-MPP.

domestic economy. Handing most of Hungarian trade over to foreigners was also detrimental to domestic actors and to the society at large. The Christian Democratic People's Party will try to stop this disastrous trend, to give domestic productive companies a competitive edge and to remedy the damage done as much as possible.

There is one final position that has extremist elements. This is the official version of the effects of foreign direct investment by Western governments. In this analysis FDI is equated with an enormous humanitarian gesture by the rich West towards the backward East and not the self-interested behavior of extremely powerful economic institutions. In a 1995 speech at the Collegium Budapest, the US Ambassador to Hungary stated "I have often been asked why there isn't a new Marshall Plan to help Central and Eastern Europe. Well, there is—it is here—-and it is called private foreign investment…. Foreign investment creates jobs, enhances productivity, generates economic growth, and raises the standard of living. It brings new technology, new management techniques, new markets, new products, and better ways of doing business" (quoted in Gowan, 1995; p. 10). FDI was a crucial element in the 'blueprint' for capitalism exported by Western academics and International Financial Institutions (such as the IMF, World Bank, EU, the European Bank for Reconstruction and Development, and the Phare program. See Hanley et al., 2000). FDI, when combined with an opening of all markets and fiscal austerity to harden the budget constraints of domestic actors, would provide the economic dynamism necessary to close the developmental gap between the post-Communist countries and Western Europe (see Appendix 2 for the sources from which these positions are drawn).

Table 1 provides data on the parties, the percentage of the parliamentary seats in

Table 1
The Distribution of Opinion about FDI in Hungary's 1994–1998 Parliament

Party	Politics	% of Parliament since 1994 Election	Stance on FDI
Worker's Party	Extreme left	0%	Very negative
Hungarian Socialist Party	Center-left	53%	Very positive
Party of Free Democrats	Liberals	0%	Very positive
Hungarian Civic Party	Center-right	8%	Mixed-positive
Hungarian Democratic Forum	Center-right	5%[a]	Mixed-neutral
Independent Small Holders' Party	Populist/center-right	6%	Strongly negative
Christian Democratic People's Party	Extreme right	3%[a]	Strongly negative
The Party of Hungarian Truth and Light	Extreme right	0%	Strongly negative

[a] Reflects the fact that there have been major changes in the parliamentary representation of the party since the 1994 election.

the 1994–1998 Parliament that they control, their ideological position (in 1998) and their opinion concerning FDI. It is clear that the pro-FDI position won the day. Was this beneficial for the Hungarian economy?

Ignoring for the moment the possible and purported political and cultural affects of FDI, the various arguments that litter the political field can be organized into the effects that foreign direct investment has on four areas of economic activity, the first three essential for a country to 'catch-up' with the West and the fourth with a more complicated relationship to development: (1) increasing the amount of investment capital; (2) increasing labor productivity; (3) increasing domestic productive capacity; and (4) the de-monopolization of the economy (Table 2).

The various mechanisms by which foreign direct investment might affect the local economy can be thought of as so many hypotheses. As is clear, the two theoretical traditions have identified multiple, and competing, mechanisms by which FDI affects the economy. All these mechanisms will be illustrated and discussed below with the case studies.

Table 2
The contradictory theoretical expectations on the impact of foreign direct investment on the host economy

Effect on the economy	Dependency	Modernization/neoclassical
Effect on amount of investment capital	Sucks out capital that could be used for investment through: (a) repatriation of profits; (b) crowding out local borrowers	Adds investment capital through: (c) direct investment from foreign company; (d) providing access to Western banks
Effects on labor productivity	Reduces labor productivity: (e) utilizes low skilled low value added labor; (f) eliminates local R&D capacity	Raises labor productivity through: (g) increasing skill levels via training and demonstration; (h) better utilization of labor through Western management techniques; (i) technology transfer; (j) driving inefficient firms out of business thereby freeing up resources for more efficient producers
Effects on level of competition	Reduces competition by: (k) Preserving and/or creating monopolies and oligopolies; (l) too strong (and unfair) competition which kills domestic producers	Increases competition by: (m) creating new market actors
Effects on domestic productive capacity	Reduces domestic capacity by: (n) 'purchasing markets'; (o) substituting foreign suppliers for domestic suppliers	Increases domestic capacity through: (p) increasing demand for local suppliers; (q) increasing demand by providing access to Western markets; (r) increasing demand by creating high-paying jobs

Findings

The case study data provides great insight into the variation of the effects that foreign investment has on the post-communist economy. Different modalities of foreign investment are created by the interaction of the foreign partner with local managers, state technocrats, politicians, and aspiring entrepreneurs. A rough typology inductively constructed includes: (1) small joint ventures with former socialist-era managers; (2) large enterprise privatization by multinational corporations; (3) the establishment of new businesses owned by foreign owners; and (4) large joint ventures. We will illustrate the nature of these different types with some case study evidence.

Small joint-ventures

One strategy of combining foreign and local capital is to create small joint ventures between foreigners and former managers of state owned enterprises. In this scenario a socialist era manager forms a private company that can be thought of as a rough duplicate or 'clone' of his or her old division (or part of a division) of the state owned enterprise were they previously worked. Many new firms have been created in this way at least in Hungary (see King, 1997, 2001a,b; Rona-Tas (1997). The foreign variety of this process consists of forming such a company, and then negotiating a business arrangement with a representative of a foreign firm. Typically the manager met this representative during the socialist period. The foreign partner may be a part owner of the firm, thereby establishing a joint venture; or they may have a symbiotic relationship based on either the local firm selling the products of the foreign firm, or producing commodities for export to the home country of the foreign enterprise (cases 3, 4, 6, and 7 followed this pattern). While most small industrial firms in Hungary were formed in this manner, not all stayed small. Some very small capitalist enterprises turned into medium, and for a few, even large enterprises. Case 7, which was a poultry business started by a former manager of the poultry division of an agricultural cooperative, had reached 300 employees by 1995, from less than 30 just a few years before.

The advantage of this kind of foreign investment is that it provides the post-communist firm with capital for daily operating expenses and especially for investment, both very scarce in the post-communist context (hypothesis c). For any small firms not able to participate in 'clientelist' networks with banks that are dominated by larger companies with much better connections, this might be the only way to get significant amounts of investment capital (see King 2001a,b). In addition, the firm gains access both to foreign products and to foreign markets (hypothesis m). The economy as a whole benefits because an increase in new market entrants reduces monopolization. These firms have the additional advantage of creating a structure of ownership and control whereby the Hungarian partners effectively controls the firm: this scenario increases the likelihood of the reinvestment of profits in the local economy and the establishment of 'linkages' with other firms in the domestic economy.[7]

In many of the interviews with firms that followed this pattern, evidence consistent with modernization theory could be found. Many of the local business owners expressed 'Western' or 'entrepreneurial' values. A typical interviewee (case 4) stressed that it was his exposure to "another way of doing things" when he worked and traveled through Western Europe that made him want to run his own company. Indeed, a secularized version of the "Protestant ethic" was obviously apparent during many of these interviews.

Foreign privatization of large state owned enterprises

In stark contrast to this "manager turned small capitalist Joint Venture" there is a more familiar variety of foreign investment: a multinational privatizes a large state owned enterprise. This too results from a distinct managerial strategy, in which old socialist managers seek to become members of the upper management of a foreign company. Managers can help multinationals by concealing their firm's assets to reduce the cost of privatization, or, minimally, by providing exclusive accurate information about their enterprises. This strategy is sometimes referred to as becoming a member of a "comprador intelligentsia" (Szelenyi, 1995; Eyal et al., 1998), a term which implies that these managers grow wealthy by assisting foreigners in gaining economic control and dominance over their society.

This is an attractive strategy for most managers, as the wealth and prestige that go along with being a member of the management of a foreign multinational are quite substantial. Managers are not disproportionately fired in this situation, as employment guarantees are often included in their privatization plans.[8] In all of the case studies, managers of big multinationals earn significantly more than managers of domestically owned firms. For example at a famous German Pharmaceutical company (case 21), the executive reported that they pay their employees one-third more than Hungarian firms, and Americans pay one-third more than them.

The wholly privatized firms in the case studies were always strengthened by the capital such privatization brings. In seven of the eight such cases for which interview data was available, one could clearly see other benefits as well, such as management expertise (especially in marketing). Many (though not all) also benefited by new access to Western markets. Perhaps most importantly, these firms made investments that simply would have been impossible if the firm relied on only domestic resources.

[7] Of course, this assumes that profit made by local capital is less likely to take flight. While this is probably true in Hungary, there are certainly environments where local capital can be fairly volatile as well, as in Russia.

[8] According to a survey of large and medium size firms in 1996 24.5% of foreign owned firms report a change in management planned for 1997, compared to 28.6% for state owned enterprises and 29.3% for enterprises with significant state and private ownership, although more are fired than in manager owned (15.6%) and employee owned firms (14.3%) (see King, 2001a).

Among the biggest firms privatized by foreigners, some of the investments have been enormous by Hungarian standards. Case 56, which was a refrigerator company privatized by a giant Swedish based Multinational, received an external loan for 8.9 million US Dollars in 1995. Thus, as with the smaller case studies discussed earlier, FDI means greater access to international capital at substantially lower real interest rates (which supports hypothesis d). Case 52 (a consortium of Ameritech International Inc and Deutsche Telekom AG) privatized the Hungarian telecommunications giant. The overall investment in this company was massive. In 1996, for example, out of Hungary's 700 billion HUF worth of real investment, this firm alone accounted for 70 billion.

Of course, the beneficial effect of this investment will be mitigated if the profits from that investment get repatriated out of the domestic economy. It is true that some of the very biggest privatizations of state owned enterprises resulted in large amounts of repatriated profits. One of the 50 largest companies in the country, and one of the big four pharmaceutical companies (case 29) is 98.7% owned by French capital. The company paid out dividends of 31% of after-tax profits in 1995. This had risen to a startlingly high 97% in 1996. They repatriated 46.56 million dollars in 1995 and 1996. By 1998, the rates remained a high 65%. Indeed, the first chairman of the board, a Hungarian, resigned in 1994 because of the high dividends paid out. Of course, it is true that the company has invested a very large amount of resources in Hungary (by Hungarian standards). The company has invested over 200 million USD in Hungary as of 1998. What these data do not reveal is whether this 200 million was essentially a one shot deal or not. If this initial investment does not generate future investments, the 200 million net invested will quickly be exported out of the country through profits.[9]

However, this pattern of high rates of profit repatriation by large foreign owners is not the only pattern to be observed. A relatively modest 23% of all profits were repatriated by another top 50 company (also a leading Pharmaceutical firm privatized by the French (case 36) in 1998). Among the ten biggest foreign owned firms in the country, the scattered findings revealed other firms with dividend rates in the low twenties as well.[10]

The FDI-negative position would counter that while foreign firms might be investing, this capital may be going into the 'wrong' things. One plausible story from this perspective is that foreign investment in Hungary is primarily in low-wage, low value-added, labor (hypothesis e). Clearly, 'specializing' in low skilled cheap labor is not the way to 'catch-up' with the West, given that Hungary's comparative advantage rests with highly skilled, but relatively inexpensive, labor. These types of investments will likely result in little reinvestment of profits, a result of low payments

[9] Based on court records and Népszabadság 02/26/98; Magyar Hírlap 4/22/98, p. 1; Cégvezetés 1/1994, p. 94; Magyar Hírlap 4/22/98, p. 10.

[10] Of course, dividend rates for MNCs are notoriously inaccurate given the variety of mechanisms, like transfer pricing, to extract profits other than by declaring high dividends. However, since most of these firms had substantial tax holidays, we would expect transfer pricing of profits into Hungary, and thus the need to pay out dividends to extract profit.

for this 'link' or 'node' in the 'international commodity chain'. That is, most of the profits accrue in retail in the West European or North American country of the final sale (see Storper et al., 1998; Gereffi and Korzeniewicz, 1994).

The issue of using low-wage labor is related to the issue of local research and development capacity. According to learning theories of economic growth (Storper et al., 1998) local networks of high-tech, highly specialized people and institutions make possible a constant adaptation, and upgrading, of production techniques. It is the local R&D capacity that determines whether firms in Hungary will constantly adapt the newest technologies. The case study data reveals that although low wages was definitely part of the motive for many foreign investors, this did not preclude the upgrading of technology at all. In fact, while most of the firms in the clothing industry provided little value added and were not seeking to compete by adopting superior technology, this was not the general pattern in all the sectors. In the pharmaceutical sectors, for example, massive investments were made that greatly contribute to Hungarian development. A clear example of this is the French privatization of another big four Hungarian pharmaceutical company (case 27). In 1996, the firm introduced the first original Hungarian medicine in ten years. In 1998 it developed two new contraceptive drugs. These innovations were the pay-off for significant investments in R&D (which were 7% of its sales revenue in 1997). In fact, the French and Swiss purchased the entirety of the leading firms in the Hungarian pharmaceutical sector. The uniform result was an impressive increase in R&D, investment, wages, and exports.[11]

Not all of such large scale privatizations result in investment into R&D. One of the most controversial privatizations in these regards was the purchase of the Hungarian technological flagship light bulb maker Tungsram by General Electric (case 55). General Electric deemed the local R&D so 'noncommercial' that it was disbanded (Világgazdaság 4/24/98). Eventually, much later on, and starting from scratch, some R&D capacity was re-established. Another example is in the high-tech industry of Aluminum smelting, where the American giant Alcoa purchased a huge Hungarian Aluminum factory. Court Registry data reveals almost no spending on R&D up through 1997.

While some FDI does not result in increases in R&D, at least among the case studies foreign owned firms were far more likely than domestically owned firms to make such investments. Why is this? One answer might be that FDI is not only after Hungarian market share, but market share in other parts of the global economy as well. One example that illustrates this is a fully privatized pharmaceutical firm (case 34). Interviews with the CEO reveal that the French bought the Hungarian pharmaceutical company (which had existed for over a century) to produce the drugs that they specialize in, biological based pharmaceuticals, to sell not only in Hungary, but also in Russia, Ukraine, Western markets as well as the rest of the world. The French MNC made a massive investment in the plant to raise it to world levels of production.

Another claim that requires close scrutiny is hypothesis k, which states that foreign

[11] Based on court records, see also Magyar Nemzet 3/21/98.

investment adds to the monopolistic tendencies of the post-communist economy. An important example, which lends some support to this hypothesis, is the transformation of the Hungarian supermarket sector. The dominant foreign company was Julius Meinl, which is one of the leading oligopolies in Austria. (Case 56). A major Hungarian food retailer, Kunsag, was technically 'merged' with Julius Meinl (so that the Austrian firm would get to write-off Kunsag's debts on its taxes). In 1991 it bought a chain of 214 Duty Free stores. In 1998, 19 food stores in villages around Budapest were added to the corporate hierarchy. After this purchase, it bought the Jumbo supermarket in the Northern suburbs of Budapest in 1997. Thus, following a privatization, there has been significant concentration is the food retail sector under the aegis of a single foreign company.[12]

Another clear example is GE Tungsram—which maintained its 95% share of the domestic market in light bulbs (Külgazgaság 6/22/1998, p. 7). "Tunsgram was a unique acquisition opportunity, bought for its market presence [both domestic and in Western Europe]: Vice-Chairman Peter Wohl admitted" (Business Central Europe, 11/9/1991, p. 16). Or the phone company (case 52), which has a monopoly on the local phone calls in 32 of 54 telephone regions, for more than 80% of total primary telephone access in Hungary as well as an exclusive concession to establish quality overseas calls (Figyelõ 03/12/1998). Currently, the company is trying to secure its monopoly position for after the time its concession runs out in a most aggressive manner. The foreign refrigerator maker (case 56) had 68% of the Hungarian market in 1991, up to 85% in 1994, and has remained above 80% up to 1998 (Figyelõ 05/28/1988, p. 6). Of course, not all monopolistic/oligopolistic positions are equally bad for the economy. For example, while the phone company, Matáv, charges a shameless monopoly rate, the refrigerator company's (case 56) market is quite contested, so all it can reap are the gains deriving from its geographical situation. Moreover, if FDI is creating export oriented firms, having domestic monopolies or oligopolies is to be expected from purely economy of scale considerations because most big firms in Central Eastern Europe are actually too small by world standards (see Amsden et al., 1994).

Even more serious than reinforcing monopoly, some foreign investment might engage in 'market destroying' behavior (Matzner, 1995). In this variant of foreign investment local suppliers may lose their primary customer once a company is privatized, causing a decrease in overall demand (hypothesis o). Or, even worse, the privatizing multinational might eliminate the local productive capacity of the newly acquired firms (that is, sell final products made elsewhere in the multinational empire) (hypothesis n). The FDI-positive rebuttal is that foreign investment will make it easier for firms to export, which in the long run is the most likely guarantee of increasing a country's labor productivity. For example, observers had worried that the multinational that privatized the Hungarian refrigerator company was going to purchase the firm's market (Magyar Hírlap 5/28/1998, p.6). However, the privatized company, because of its significant cost advantage due to the local price of labor,

[12] Based on court records, see also HVG 9/27/98; Üzleti 02/23/98; and Magyarorszag 11/18/1997, p. 7.

has actually absorbed the multinational's British and Italian plants' capacity-creating growth in Hungary. Partially as a result of the firing of redundant labor, labor productivity in the plant increased by 80% from 1991 to 1993.[13]

There is also evidence for the pro-FDI expectation that foreign investment will stimulate local parts suppliers. For example, there are reports that more than 2000 Hungarian small and medium firms worth over $150 Million in 1998 served as suppliers to Tunsgram (Magyar Hírlap 11/1997, p. 173). Most of the firms in the case studies used local suppliers in addition to some imports. But the domestic firms also used imported inputs, if at a lower rate than the foreign firms.

Greenfields and subsidiaries

In addition to privatization, subsidiaries of Multinational firms have expanded dramatically and are now significant economic actors (about 48.5% of foreign investment was spent on privatizing state owned enterprises). These firms were not that different from large privatized state owned enterprises. They too made very large investments as a result of superior access to finance. For example Suzuki, which manufactured 63,500 cars in Hungary in 1997, brought 82.7% of its initial 11 billion HUF investment in the form of Japanese loans in 1991.[14]

However, these MNCs may be even more prone to export profits out of the country and to use externally produced inputs. Take as an example IBM Storage Products Industrial Duty Free Zone Limited Liability Company (case 54), 100% owned by IBM. Founded in 1995, by 1997 it was the second largest enterprise based on revenue in Hungary. In that year, according to Court Registry Data, it paid out all profits as dividends. These firms might also import more inputs. Audi's engine factory (case 59), for example, while responsible for a very large investment, purchases almost no inputs locally. "Its local content is close to zero, with components shipped in from Germany, slotted together, and then shipped back" (Business Central Europe, April 1998, p. 44).

The final type of foreign investment exacerbates the negative tendencies found in Greenfields: large joint-ventures and the use of subcontracting.

Large joint-ventures and sub-contracting

Some privatization by foreign direct investment is not transformative in any way and strongly relies on the sub-contracting of products to be sold to Western firms. In this scenario, foreign firms utilize the huge capacity of former socialist firms in order to capture the low cost of labor (hypothesis e). Super cheap labor (at least ten times as cheap), combined with proximity to Western Europe, seems to be a motivat-

[13] Based on Court Records and Világgazdaság 3/12/1998 and 2/24/1998 and Figyelõ 11/11/1993, p. 33.
[14] Based on Court Records and Világgazdaság 2/24/98 and HVG 4/20/92, p. 8.

ing force behind some foreign investment in Central European low-tech manufacturing firms.

One example of this form of foreign direct investment from the case studies is a relatively large firm located on the Western border of Hungary (case 1). This firm was founded in 1951 and made light rain jackets sold only in Hungary. In the early 1960s they started selling to the Soviet Union, in the mid-60s to Holland, and then to France and England. By the end of the 1980s they no longer sold to the Eastern block, but exported mostly to the West. Because they were able to successfully sell to Western markets, the regime gave them a great deal of money for technological investment, and, by the mid-1970's, their level of productivity had been only slightly below the West European average.

In 1990 they underwent a process of privatization. The resulting ownership structure was 30.6% by a consortium of foreign investors, 3.2% by domestic Hungarian investors, and the rest by the State Property Agency. In 1995, the foreign owners had increased their share to 50.4%, managers and workers received 3%, the local government received 5%, and the State Property Fund held the rest.

The consortium of foreign owners consists of seven clothes production companies (three Austrian, two Italian, one Swedish, and one American) and a British financial service company. The firm's activities consist primarily of combining foreign inputs and foreign designs with the large and very inexpensive female labor force to stitch the clothes together. The interviewees (the president and chief financial officer) said that no real change in either production or marketing had occurred since the late Communist period. The foreign investors, interested only in their cheap labor, do not invest any funds to raise labor productivity. Indeed, the interviewees stressed that without receiving a major infusion of capital they could not modernize beyond the level they attained in the late 70s. Even their rate of profit, the very low 6-8% of gross receipts, has remained constant since the Communist period. The story for the Apparel firms' suppliers corresponds to the extremists' worst expectation-domestic textile production has all but been eliminated-and now all Hungarian apparel firms use imported textiles.

The physical appearance of this company was much different from the appearance of any of the large companies fully privatized by an MNC. The building was quite old, the lights in the hallways were all burnt out, no trace of a high-tech security system was to be found, and, indeed, there was no advanced technology to be protected. Since the transition there has been an increase in competition faced by the firm from the other low wage areas—Poland, the Czech Republic, Romania, the former USSR, and now Brazil. Hungary can not win a race to the bottom in wages, nor should it aspire to do this.

Conclusion

We have argued that there are four different types of foreign direct investment in transition economies: (1) small joint ventures; (2) large scale privatizations of entire companies; (3) Greenfields; (4) and large joint ventures. Table 3 summarizes the

Table 3
The economic effects of different types of foreign direct investment in Hungary (source: 72 case studies; ++, large positive effect; +, positive effect; −, negative effect; −/+, no net effect)

	Investment Capital	Labor Productivity	Domestic Demand	Competition
Small JVs	+	+	+	++
Large Privatized	++	++	+	−
Greenfields	++	++	−/+	+
Large JVs	+/−	−	−	−/+

evidence from the case studies on the different developmental consequences of the different types of foreign investment relative to domestic companies. A '++' represents a major contribution to an area, and a '+' a smaller one, and a '−' means there is a negative effect. Since these conclusions are based on a non-random sample of case studies, they should be thought of as hypotheses only.

There are two major conclusions we want to draw from the case studies. The first is that the theories that see FDI as 'good'‘' or 'bad' miss the point that 'it' is several things. In fact, some types are overwhelming good for the economy, and some are probably very bad for the economy. Social scientists should distinguish the effects of different types of FDI, so that policy advice can be fine tuned by more explicitly targeting the helpful varieties. The second conclusion is that, taken all together, FDI has been very beneficial in the transition to capitalism in Hungary. The best thing about FDI is the amount of investment capital and access to foreign markets that it brings. However, these benefits might disappear over time if foreign firms succeed in establishing monopolies. Monopolists might charge higher than perfect competition prices, rent-seek, and under-invest in R&D. To make matters worse, these foreign owned companies may repatriate most of their profits. In addition, the importing of intermediary goods may be damaging in certain sectors, and even wipe them out as in the textile industry. On this last point, advocates of FDI could counter that while the elimination of certain sectors might be bad in the short-run, it might be good in the long-run, replacing industries where Hungarian comparative advantages are questionable with industries where they are sizable.

Still, this possibility of a growing monopolization of the economy combined with a repatriation of profits may well be a recipe for stagnation over the long-run. On the other hand, the growth of large firms, if combined with investment and exports, is probably a necessity for small post-communist countries to catch-up with the West. Even Taiwan, among the most successful late developers noted for the prominence of its small and medium size firms, has larger big firms than Hungary. (Amsden et al., 1994).

While foreign ownership theoretically might still damage the economy in the long-run, based on the data that is in, foreign ownership seems to have had a large positive effect on the Hungarian economy. What is clear is that foreign owned firms had far superior access to investment capital compared to domestically owned companies. Many sectors in these post-communist countries need massive amounts of new investments to be internationally competitive, and FDI is the most likely source of such investment.[15] Also, FDI makes exports to Western Europe possible. The importance of this effect seems evident when one notes the overwhelming historical record on the value of gaining an increased share of the world market in making possible real development in the post World War II period. Germany and Japan modernized their economies during the 1950s and 1960s by capturing an increasing share of the U.S. market, much as South Korea and Taiwan were able to capture export markets in the 1970s and 1980s, and now the Chinese in the 1990s (see Brenner (1998).

Thus, it seems quite probable that foreign direct investment benefits the host country and aids the transition to a market economy. However, it is also possible that foreign investment is good in Hungary and Central Europe, but damaging elsewhere in the post-communist world (such as Russia and Ukraine). For instance, some multinationals have made massive investments in Hungary (e.g. in pharmaceuticals) to produce generic drugs to sell in the Eastern markets of the former Soviet Union. These Hungarian based firms, if they are able to ‘purchase’ Russian markets, might result in development for Hungary and France, and underdevelopment for Russia.

What this analysis may ultimately suggest is that countries should be careful about what type of foreign investment is welcome. Of course, states should make it clear that all types of ownership will be treated equally before the law and should not endanger the general trust in the country by the international financial community. Still, there are many dimensions (such as special tax-breaks, attitudes towards transfer pricing, tariffs) where one can and should distinguish between different classes of FDI. Integration that is based on purchasing domestic distribution channels, and doing low value added contract work, is not likely to close the gap between Eastern and Western Europe. What is needed is foreign investment in capital-intensive manufacturing enterprises that export to Western Europe. Such investment might combine either new or recently obsolete technology from the Advanced economies with much cheaper but still highly skilled labor, which, when combined with the low transportation costs to Western Europe, can be quite profitable in the long-run. If this technology can be constantly adapted, and upgraded, and successfully exported, it can provide a motor for closing the gap between the post-communist world and Western Europe by raising living standards and capital investment in a virtuous circle that has characterized much of European post-World War Two development. Whether this is so will, in large part, depend on what the state does to create the institutions that support such industrial learning.

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[15] An economist would say that individual managers face a capital market that is underdeveloped in many ways.

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Appendix A

Description of cases (I=Interview; CR=Court Records; P=Hungarian business Press)

Case number	Activity	Number of employees	Ownership	Data
1	Clothing	1800	JV	I, CR
2	Bank	30	Foreign	I, CR
3	Electronic equipment	40	JV	I, CR
4	Electronic equipment	25	JV	I, CR
5	Chemical	250	Domestic	I, CR
6	Hospital equipment	15	Domestic	I, CR
7	Agribusiness	300	Domestic	I, CR
8	Financial Consultant	7	Domestic	I, CR
9	Furniture	300	Domestic	I, CR
10	Electricity	400	State	I, CR
11	Diversified Hold. Co.	2500	Foreign	I, CR
12	Agriculture Trade Co.	1300	Foreign	I, CR
13	Chemical Machinery	160	Domestic	I, CR
14	Petroleum Machines	500	Domestic	I, CR
15	Petroleum	19000	Domestic	I, CR
16	Chemical	1500	Domestic	I, CR
17	Telecomm. Compon.	800	Domestic	I, CR
18	Chemical engineering	200	Domestic	I, CR
19	Electronics	1500	Domestic	I, CR
20	Furniture	252	Domestic	I, CR
21	Pharmeceut	197	Foreign	I, CR

Case number	Activity	Number of employees	Ownership	Data
22	Furniture	22	Domestic	I, CR
23	Clothing	130	Foreign	I, CR
24	Clothing	200	Domestic	I, CR
25	Hold. Co. Aluminum	Under liquidation	Domestic	I, CR
26	Clothing	117	Domestic	I, CR
27	Furniture	20	JV	I, CR
28	Phramaceut	2632	Foreign	I, CR, P
29	Pharmaceut	2816	Foreign	I, CR, P
30	Pharmaceut	50	Domestic	I, CR
31	Pharmaceut	33	JV	I, CR
32	Pharmaceut	120	Domestic	CR
33	Pharmaceut	73	Foreign	CR
34	Pharmaceut	483	Foreign	CR
35	Pharmaceut	43	Foreign	CR
36	Pharmaceut	4319	Foreign	CR, P
37	Furniture	54	Domestic	I,CR
38	Furniture	85	Domestic	CR
39	Furniture	69	Private-Pub. mix	I, CR
40	Furniture	162	Domestic	CR
41	Furniture	560	State	CR
42	Furniture	207	Domestic	CR
43	Furniture	46	Domestic	CR
44	Aluminum	1031	Domestic	I, CR, P
45	Aluminum	585	Foreign	I, CR, P
46	Aluminum	1036	Domestic	CR
47	Aluminum	588	Foreign	CR
48	Aluminum	340	Domestic	CR
49	Petroleum	661	Foreign	CR, P
50	Car parts	200	Foreign	CR, P
51	Gas Import	20	JV	CR, P
52	Telecom	20821	Foreign	CR, P
53	Cars	1570	Foreign	CR, P
54	Computers	278	Foreign	CR, P
55	Lightbulbs	10424	Foreign	CR, P
56	Refrigerator	2664	Foreign	CR, P
58	Supermarket	4084	Foreign	CR, P
59	Car engines	661	Foreign	CR, P

Appendix B

Sources for political discourse analysis

Részletek a munkáspárt programjából [excerpts from the program of the workers' party]http://www.elender.hu/munkaspart/reszletek1.html

A KDNP programja [the program of the Christian Democrats] http://www.kdnp.hu

Az MDF választási programjából [from the election program of the Hungarian Democratic Forum] http://www.mdf.hu/valasztas98/mdf_valasztasi_prg_98.htm#3

A magyar telephelyklfvldi [the government program of the Free Democrats] http://www.szdsz.hu/program/kormanyzati_program_gazdasag.html

Parliamentary Records. Varga Mihály (FIDESz) parlamenti beszéde, 1996 10 30, a FiDESz vezérszónokaként az 1997-es költségvetési törvényvitájában

[The speech of Mihaly Varga [Fidesz] in the debate of the 1997 budgetin Parliament, 10/30/1996]

Newpapers:

Faggyas Sándor interjúja Matolcsy Györggyel a Magyar Nemzet 1997 november 8-i számában [an interview with Gyorgy Matolcsy, Fidesz's shadow minister of financeby Sándor Faggyas, in the daily Magyar Nemzet, 11/8/1997]

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Ha korábban lépünk, kisebb az áldozat
Hámor Szilvia interjúja Antal Lászlóval

[an interview with László Antal, advisor to the minister of finance, by Szilvia Hámor, in the daily Népszabadság, 3/14/1998]

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