

VOLUME 10

NUMBER 3

DECEMBER 2001

TRANSNATIONAL CORPORATIONS



United Nations
United Nations Conference on Trade and Development
Division on Investment, Technology and Enterprise Development

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ISSN 1014-9562
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Transnational Corporations

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Privatization and greenfield FDI in Central and Eastern Europe: *does the mode of entry matter?*

Introduction and summary

Kálmán Kalotay

Questions about the mode of entry – greenfield investment versus cross-border mergers and acquisitions (M&As) – have come to the forefront of discussions on the benefits of foreign direct investment (FDI). The discussion usually assumes that, at the time of deciding about an investment project, both the potential investors and the host countries have a choice between these two modes of entry. All they need to do is to evaluate the costs and the benefits of the two choices, and formulate their strategies accordingly. In this model, host countries often find greenfield FDI more advantageous for them, because, unlike in the case of M&As, in greenfield projects investors always create new capacities.

This issue of *Transnational Corporations* is devoted exclusively to an exploration of how relevant this ideal world is for Central and Eastern European countries undergoing economic transformation, especially through privatization. As it turns out, unlike in a textbook case, the two modes of entry are practically never substitutes for each other in Central and Eastern Europe because these two basic types play different roles in the transformation from a centrally planned to a market economy. Greenfield FDI provides new facilities while cross-border M&As contribute more to the restructuring of existing capacities. This means that, going beyond the traditional question of “which form is better”, another question needs to be asked, namely: “which mode of entry serves transformation better under specific conditions or in specific industries”.

In the initial phase of transformation, almost all cross-border M&As took the form of “foreign privatization” (sales of privatized assets to foreign investors) as, with some exceptions, most of the Central and Eastern European countries started their transformation with practically no or very small private enterprises. By default, the only assets foreign investors could acquire were former State-owned

assets. Once the generic differentiation between greenfield FDI and cross-border M&As is made, it is legitimate to focus on foreign privatization as a specific and overwhelming form of the latter. That greenfield FDI and cross-border M&As are poor alternatives to each other is quite obvious when looking at the foreign privatization form of the latter: only foreign privatization could bring about the transformation described in this issue, without greenfield investment being a real alternative.

Some of the articles in this issue analyse FDI from the angle of foreign privatization; others do it from the angle of cross-border M&As versus greenfield investment. The conclusions are similar: whether one calls the phenomenon “foreign privatization” or “cross-border M&A”, it has been a major component of transformation, although it could have played a bigger role than the one assigned to it by special political constraints.

This issue does not intend to propose definitive policy answers to the questions raised. Nevertheless, it emerges from the majority of authors that the potential role of foreign privatizations has been generally underestimated in Central and Eastern Europe. The recent surge of such privatizations in several countries is an indirect corroboration of that recognition, coupled with a wish to catch up with the time lost in earlier years of transformation.

This issue also provides some insights into the ongoing debate on transformation. In this debate, certain aspects of the conventional wisdom on transformation are challenged. For example, it is no longer certain that the way in which privatization was carried out in most of the Central and Eastern Europe countries – via voucher schemes – was the only possible (or the most efficient) way of transition from State to private ownership. A strong presence of foreign affiliates allows fast restructuring, on condition that, at the same time, host Governments follow sound, efficiency-oriented and internationally competitive economic policies. The impact of privatization-related FDI depends largely on follow-up investments and on the restructuring efforts of the new owners. The role of future policies is to maximize the positive effects and stimulate spillovers to the rest of the economy.

In the lead article, *Matija Rojec* looks at the impact of foreign privatization in Central and Eastern Europe from a firm-level perspective. He warns the reader that, in general, foreign privatizations have not been able to play a major role in the overall privatization

schemes. Sales to foreign investors as a privatization method have been important mostly in the privatization of relatively large firms needing fast and thorough restructuring. Foreign privatization has nevertheless had an important qualitative impact as the entry of a strategic foreign investor resulted in an instant wish and ability to restructure and improve the target company. Most of the new (domestic) owners appearing from mass privatization schemes were unable to carry out similar restructuring.

Turning to country case studies, *Miklós Szanyi* compares privatization FDI with greenfield FDI in Hungary. He rejects the validity of the textbook case, under which – in the case of privatizations – investors would not need to change much the physical assets they purchased. This is certainly not the case in real life in economies in transition. Another important issue is whether companies could have done restructuring on their own, without foreign investors? The fact that the insertion of newly acquired facilities into international corporate networks has required more efforts than in the case of usual M&As elsewhere seems to indicate that foreign privatization has indeed played an exceptional role in economic transformation.

Katalin Antalóczy and *Magdolna Sass* take this Hungarian case further by testing again the traditional question, i.e. has greenfield FDI been better in Hungary than privatization-related FDI? The article also deals with the special relationship between greenfield investment and export processing zones in manufacturing. Through analyzing the most important characteristics of greenfield FDI in Hungary – such as its industry and geographical concentration, local embeddedness, employment creation, capital accumulation, technology transfer, competition and productivity – the authors conclude that the two forms have indeed been no substitute for each other. It is interesting to note, for example, that, compared with the sum invested, and in comparison with privatization investments, relatively few new jobs have been created, indicating that greenfield investment by no means offered a solution to the full range of restructuring problems.

To complement the analysis of the Hungarian case from a policy angle, *Peter Mihályi* asks the question how Hungary has become a success case of post-communist privatization. He argues that, by emphasizing macroeconomic stabilization and fast formal ownership change over a concern for who the real owners are, policy makers have for many years misunderstood the *raison d'être* of privatization.

Hungary had avoided the track of fast formal ownership change because it had been forced from the very beginning to divest its State-owned enterprises against hard currency. By the mid-1990s, this policy started producing major positive results in terms of fast export-led growth.

In the subsequent article, *Stanislaw Uminski* assesses the influence of privatization-related FDI on enterprise performance in Poland. As there have been three distinct channels for privatization which are difficult to compare, it is almost impossible to obtain reliable, complete and comparable statistical data on all privatization deals in Poland involving foreign investors. While this is a problem for statistics, the fact that investors could choose among different methods made the whole process more flexible and adjustable to both the firms to be privatized and to the investors, depending on their situation. The performance of the firms privatized to foreign investors, both in terms of qualitative changes and of financial measures, have been better than that of the firms privatized locally.

Alena Zemplerová and *Martin Jarolim* analyze the role and impact of M&As and greenfield manufacturing FDI in the Czech Republic through a statistical and regression analysis, through classifying the sample of the firms analyzed by ownership (foreign or domestic) and mode of entry (greenfield or M&A). The authors find greenfield firms to be significantly smaller on average than firms acquired through foreign acquisitions. The former, however, have a higher investment rate than the latter. As for productivity growth, both groups of foreign affiliates perform well; M&A firms have nevertheless achieved slightly higher productivity growth than greenfield enterprises. The impact of both groups of foreign affiliates on the productivity growth of indigenous firms is positive. Market concentration can however cancel out the positive impact on productivity growth in industries with insufficient import competition.

To provide a broader regional outlook, *Marina Wes* and *Hans Peter Lankes* analyze in the last note the difference between greenfield and M&As in various countries of Central and Eastern Europe and the Commonwealth of Independent States. They find that production-oriented greenfield FDI projects tend to be large and more capital-intensive than M&As. This suggests that greenfield investors attach greater importance to production costs than M&A investors. On the other hand, they conclude – and other authors in this issue further corroborate this – that M&As tend to have greater local content in

production, and more extensive relationships with local suppliers/customers than greenfield investors do.

This issue of *Transnational Corporations* does not cover all countries and industries. The shortness and unevenness of historical experience first make this difficult. Only a few countries and industries have enough experience to be analyzed in-depth at this point of time. The contributions are also a function of the responsiveness of experts in the field to analyze this topic on short notice: most of the studies in this issue were prepared for the “Seminar on Foreign Direct Investment and Privatization in Central and Eastern Europe”, organized jointly by UNCTAD and the Austrian National Bank and held on 2–3 March 2000 at the Austrian National Bank in Vienna, Austria. They were at a later stage complemented by other articles specifically invited to broaden the horizon of the analysis. It is hoped that policy makers can draw lessons from the contributions in this issue as regards their own situations when faced with issues related to greenfield FDI and cross-border M&As.

It is useful to read this issue together with UNCTAD’s *World Investment Report 2000: Cross-border Mergers and Acquisitions and Development (WIR2000)*.¹ The workshop in Vienna was organized by the team preparing *WIR2000* with the intention to discuss issues that would later on make their way into the *Report*. *WIR2000* did indeed use extensively the materials presented in this issue, put into a global context. But this material proved to be much richer than the limits of a concise *Report* would permit. It was therefore decided that, to do justice to the depths of this material and the complexities of transformation, it was useful to publish it in this issue of *Transnational Corporations*.

This issue does not contain the full range of presentations made at the Seminar – for different reasons. The introductory presentations by Anne Miroux (UNCTAD) and by Sanjaya Lall (University of Oxford) are not included because these were “in-process” papers from the *WIR* team that eventually became parts of *WIR2000*. Nor does this issue contain Kálmán Kalotay’s and Gábor Hunya’s presentation, as it was published earlier.² Finally, it was

¹ *World Investment Report 2000: Cross-border Mergers and Acquisitions and Development* (New York and Geneva: United Nations), United Nations publication, Sales No. E.00.II.D.20.

² “Privatization and FDI in Central and Eastern Europe”, *Transnational Corporations*, 9 (1) (April 2000), pp. 39-66.

decided not to include the study by David Floyd on Poland and the case studies prepared for the meeting and the *WIR2000* by Valdas Samonis (University of Toronto), Tony Wesolowsky (Radio Free Europe) and Sonia Ferencikova (Bratislava University of Economics), due to space limits.

The Seminar also had an informal session on “Policy issues regarding FDI-related privatization” at which experts from CzechInvest, the Lithuanian State Property Fund, the Macedonian Privatization Agency, the Polish Ministry of Treasury, the Hungarian Office of Economic Competition, the Slovenian Trade and Investment Promotion Office and of the Organisation for Economic Co-operation and Development exchanged views on best practices in foreign privatization. The debate was particularly interesting when the experts discussed the relationship between sales price and future commitments in the evaluation of privatization offers. This discussion is in part reflected in various articles in this issue, especially those by Rojec and Mihalyi.

We are indebted to the Austrian National Bank in general, and to Franz Nauschnigg in particular, for co-organizing and hosting the Seminar. From UNCTAD, Anne Miroux, Zbigniew Zimny, Victoria Aranda and Mark Knell made major contributions to the organization of the Seminar. At the Seminar itself, the comments made by Wilfried Altzinger (Wirtschaftsuniversität Wien), Christian Bellak (Wirtschaftsuniversität Wien), Jarko Fidrmuc (OeNB), János Gács (International Institute for Applied Systems Analysis/IIASA, Laxenburg), Gábor Hunya (The Vienna Institute for International Economic Studies), Sanjaya Lall (Oxford University), Josef Pöschl (The Vienna Institute for International Economic Studies), Michael Pfaffermayr (Austrian Institute of Economic Research/WIFO), Franz Schubert (OeNB) and Joseph Smolik (United Nations Economic Commission for Europe) were very useful in that they helped the authors to improve their texts. The full set of papers in this issue has undergone a thorough peer review by William L. Megginson University of Oklahoma (from the financial and privatization point of view) and by Marjan Svetlicic, University of Ljubljana (from the point of view of FDI and transition). Mark Knell provided major inputs to the organization and editing of the materials. Finally, the as always efficient and pleasant cooperation of Kumi Endo in the preparation of this issue is gratefully acknowledged.

The restructuring of firms in foreign privatizations in Central and Eastern European countries

Matija Rojec*

This article evaluates the impact of the acquisition of privatized firms by foreign investors (termed “foreign privatization” in the literature) in Central and Eastern Europe and derives some policy suggestions. Overall – with the exception of Hungary – foreign privatization has not dominated the privatization process of Central and Eastern Europe. Sales to foreign investors have been important mostly in the privatization of medium- and, especially, large-scale companies needing fast and thorough restructuring. They nevertheless had an important qualitative impact through restructuring and improving the target companies. New (domestic) owners born from mass privatization schemes were unable to carry out similar restructuring.

Introduction: objectives, premises and methodology

This article tests the hypothesis that foreign privatization has an immediate and positive impact on the restructuring and development of the acquired companies. This assumption is based on three premises:

- The first one is based on the potential contribution foreign direct investment (FDI) can make to the transformation of Central and Eastern European (CEE) countries. The long-term development of these typically small economies largely depends on their

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export competitiveness, particularly to geographically close European Union (EU) markets. The low efficiency of CEE economies could act, by way of determining national competitive advantages (see Czinkota, 1991; Rugman and Verbeke, 1990), as a natural entry barrier to exporting to EU markets. Upgrading national competitive advantages is the only way to overcome this barrier. By bringing in a package of machinery, equipment, technology, management and marketing techniques and expertise in an integral manner, FDI catalyzes a number of transformation processes and increases national competitive advantages (Ozawa, 1992a and b; Dunning, 1993; Czinkota, 1991).

- The second premise is based on the specific role of strategic foreign investors in the first (“formal”) phase of privatization. In this phase, the priority of nation-wide privatization schemes was to speed up ownership change, resulting in the prevalence of non-commercial methods (free distribution, preferential financing schemes, discounts, etc.) and targeting the creation of local private owners. This phase thus could contribute little to the ultimate aim of privatization in the CEE economies, i.e. to enhance economic efficiency. It is only phase two that brings in “responsible” owners with the objectives of improving company profits, efficiency and long-term development. In this phase, the privatization process consists of consolidating the ownership structure set up in phase one and of establishing appropriate corporate governance in privatized companies. The major actors in this phase are small shareholders and investment funds as sellers, and financial and strategic investors as buyers (Boehm and Simoneti, 1995, 1996; EBRD, 1994, 1998). Most of the CEE enterprises are still in an early second phase. The process of ownership consolidation and establishing corporate governance is a long and painful one as enterprises often lack the resources and the ownership-specific advantages required for speeding up their restructuring. This is where the advantages of foreign privatization come into play. It immediately moves countries and firms into a late second phase. Strategic foreign investors acquiring State-owned enterprises are the type of responsible owners who can quickly contribute to the efficiency and restructuring of the acquired companies, as well as their internationalization and integration into the global economy. In other words, it brings into the acquired companies foreign owners with entrepreneurship-determined motivations and interest in the profitability, efficiency and long-term development of the company.

-
- The third premise is based on the motivations of the host-country actors engaged in foreign privatization such as the target company's management and the host country's government agency (in its capacity as owner and seller). The primary motivations and objectives of these actors were very different from those of the actors engaged in non-privatization acquisitions.¹ The former were motivated less by the sales price and more by a wish to restructure and develop the target company than the latter. This happened so because, on one hand, in its capacity as the seller, the government agency was expected to be concerned not just with the sales price, but also with a number of macroeconomic, social and "national" issues. On the other hand, the government agency was responsible for the privatization of thousands of companies. It was not able to go into the depth of every single transaction and, therefore, had less insight into what was going on in a single target company than the target company's management did. As a result, the voice of the latter counted more than that of the agency. Managers were in most cases able to push forward their objectives in company restructuring and development, at the expense of the sales price. The sales receipt anyhow did not remain in the company but went to the State budget (Rojec and Jermakowicz, 1995).

In the absence of comprehensive firm-level data, we analyzed foreign privatization through questionnaires and interviews, carried out in 1994 at sample companies in the Czech Republic, Hungary, Poland and Slovenia. The questionnaires were addressed to approximately 370 companies acquired by foreign investors. Seventy-four of them either responded to the questionnaire or agreed to provide responses in the form of direct interviews. Although the range of the companies surveyed was wide, the representativity of the sample was far from being guaranteed. The main reasons for this were the relatively low number of companies in the sample and differences in the sampling methods applied in individual countries. Consequently, the average size of the companies surveyed differs across countries.

More than 80 per cent of the companies in the sample operate in manufacturing industries (chemicals, petrochemicals, rubber and plastics, non-metallic mineral products, food, beverages and tobacco,

¹ For the analysis and relation between owners/shareholders as a seller and target company management in general see, for instance, Bibler, 1989; Shapiro, 1990; Weston, Chung and Hoag, 1990; Morck, Shleifer and Vishny, 1991.

fabricated metal products, transport equipment etc.). Foreign investors in the Central European companies surveyed originate from 13 countries; Germany is the top investor in the sample, followed by Austria, the United States and France.

To increase the reliability of answers and to get more insight into qualitative changes, we cross-checked, as often as possible, the answers by asking the same questions from various actors (foreign investor, target company's management, government agency); and carried out in-depth interviews in as many companies as possible. Ten case studies were conducted, two in the Czech Republic (Zemplinerová, 1995), two in Hungary (Illés, 1995), three in Poland (Jermakowicz *et al.*, 1995) and three in Slovenia (Rojec, 1995).

This article will analyze three specific aspects of foreign privatizations with implications for their restructuring and development impact. The first aspect is the motivation of the target company's management and of the government privatization agency. The second issue concerns the factors leading to a winning bid and guarantees/promises given by foreign investor in the acquisition agreement. The third aspect is the type of post-acquisition changes introduced by a foreign partner and the post-acquisition performance of the acquired companies. In conclusions we will present some suggestions on how to carry out a successful direct sale as put forward by the managers interviewed.

Host-country restructuring considerations in the pre-acquisition stage

In host countries, the government (privatization) agencies and the target companies' management were the key actors in the first phase of privatization.² The question of why to attract a strategic foreign investor was especially relevant for the target company's managers. In CEE countries it is often claimed that a lack of adequate management practices was one of the major obstacles to company restructuring. In principle, that would pose a major problem as one

² In practice, the foreign privatization transactions in the CEE economies analyzed were predominantly management- and, only to much lesser extent, government-agency driven. Government agencies took a lead in the privatization of large firms. Company management was instrumental in identifying foreign investors in the case of smaller firm. (For more on that, see Rojec and Jermakowicz, 1995.)

would expect the managers – the key actors of the majority of privatization transactions – to be against a sale because it is rather probable that the foreign investor would change the managers or, at least, some of them. Our survey however identified two objectives that explicitly or implicitly led to accepting strategic foreign investors despite the apparent counter-interest. These were: saving the target company and/or securing its further development. All the other goals mentioned by the target companies' managers were objectives derived from these two primary ones. They can be classified into the following groups: (i) need for financial resources (to resolve financial problems, to financially consolidate a company, to increase capital opportunities, to gain access to new financing/new capital, etc.); (ii) new technology/knowledge (to get know-how, access to new technologies, acquisition of technological and other skills, introduction of new product lines, introduction of new international brands of products, etc.); (iii) better access to (new) markets (to increase local market share, to get access to export markets, etc.); (iv) to secure the target company's long-term development by integrating it into a foreign parent company's network; and (v) restructuring of a target company (to get resources for restructuring, to streamline the target company's mainstream activity, etc.).

Table 1 ranks the objectives of the target company's managers in a systematic manner. The necessity of securing the target company's long-term development (with an average importance of 2.7) was the most important reason, followed by obtaining new sources of finance (2.3), acquiring management/marketing skills (2.2), acquiring new technology (2.2), and entering foreign markets (2.1). A correlation analysis indicates that the acquisition of new technology ($r=0.246$) and access to foreign markets ($r=0.345$) were more important for the managers of larger than smaller target companies. Large firms, previously oriented to the local and the Council for Mutual Economic Assistance (CMEA) market, faced intensifying competition at home, while the CMEA market collapsed. These firms needed to find new markets that; in turn, was only possible with better products (i.e. new technology). The target companies' managers attached the lowest importance to the objective of accessing raw materials, components and inputs (1.3) and to employment preservation (1.5). Not surprisingly, the latter seems to indicate that, for the target companies' managers, preserving the jobs of their employees was of secondary importance when the target firms' survival (through access to finance) and development were at stake.

In bringing a strategic foreign investor into a company to be privatized, the CEE countries' government agencies attached the highest importance to the target company's long-term development, followed by the speeding up of the host economy's integration into the international economy (table 2). Only then come other objectives, such as maximizing the sales price,³ speeding up privatization and saving a target firm from bankruptcy. The pattern of responses among countries was fairly similar. Slovenia was the only outlier, where higher-than-average importance was attached to maximizing the sales price and very low importance was attached to speeding up privatization. This behaviour of the Slovenian Privatization Agency can be explained by the fact that the foreign privatization transactions surveyed in Slovenia were carried out before the mass privatization process had started – i.e. speed was not a major concern – and under a strict watch by the public and (opposition) politicians whose concern revolved around the sales price (Rojec, 1995).

Table 1. Objectives of the target companies' management

Objectives	Level of importance (max: 3, min: 1) ^a				
	Czech Republic	Hungary	Slovenia	Poland	Total
(1) To save the firm from bankruptcy	1.5	1.7	1.6	2.0	1.7
(2) To access new sources of finance	2.2	2.3	2.1	2.3	2.3
(3) To acquire new technology ^b	2.2	2.2	2.3	2.1	2.2
(4) To preserve employment	1.5	1.8	1.3	1.4	1.5
(5) To enter foreign markets ^c	2.1	1.9	2.2	1.8	2.1
(6) To get management/marketing skills	2.0	1.9	2.0	2.3	2.2
(7) To access raw materials, components, inputs	1.3	1.2	1.3	1.5	1.3
(8) To secure the firm's long-term development ^d	2.4	2.7	2.7	2.9	2.7

Source: Author's survey.

^a The average scores were derived as follows: (3) very important, (2) important, (1) unimportant.

Correlations:

^b with sales: $r=0.246$ Sig. 056; employment: $r=0.242$ Sig. 045.

^c with sales: $r=0.345$ Sig. 007; employment: $r=0.318$ Sig. 009.

^d with total equity: $r=-0.293$ Sig. 014.

³ A government agency's objective of maximizing the sales price was positively correlated with the size of the target company, measured by various indicators.

A comparison of management and government objectives (comparing tables 1 and 2) highlights that both actors were motivated by saving the target company and/or enabling its restructuring and further development. But only the managers stressed the importance of increasing management skills and of access to new resources. The government agencies, in turn, seemed to take a more macro-economic and social approach. They stressed the host economies' integration into international markets, the speeding up of privatization and maximizing the sales price. On balance, the objective of "reasonable/fair price" may be the one that was perceived radically differently – it was important for the government agencies but much less so, if at all, for the target companies' managers.

Factors leading to a winning bid

The factors leading to a winning bid and the guarantees and commitments given by foreign buyers largely mirror each other. The factors leading to a winning bid reflect a combination of the objectives (motivations) of the government agencies with those of the target companies' managers. The guarantees and commitments written into the acquisition agreements reflect how well successful bids incorporated and reflected those host-country goals.

Table 2. Objectives of the host-country governments

Objectives	Level of importance (max: 3, min: 1) ^a				
	Czech Republic	Hungary	Slovenia	Poland	Total
(1) To speed up privatization	2.3	2.4	1.0	1.7	1.9
(2) To maximize the sales price ^b	1.8	1.9	2.0	1.6	1.8
(3) To save the firm from bankruptcy	1.4	1.5	1.8	1.9	1.6
(4) To secure the firm's long-term development	2.2	2.1	2.5	2.4	2.3
(5) To speed up integration into the world economy	2.2	1.6	1.5	2.2	2.1
(6) To promote economic cooperation with a particular home country	1.4	1.6	1.0	1.3	1.4

Source: Author's survey.

^a The average scores were derived as follows: (3) very important, (2) important, (1) unimportant.

Correlations:

^b with sales: $r=0.424$ Sig. 002; with foreign equity: $r=0.571$ Sig. 001; with employment: $r=0.302$ Sig. 020; with total equity: $r=0.330$ Sig. 011.

Table 3 confirms that the purchase price offered (average importance 1.9) and investment commitments (1.9) were the leading factors making a bid win. In most cases, investment commitments had to be realized during the next one to five years. Keeping current managers (1.8) was third, followed by employment commitments to employees in general (1.6). There seems to be a kind of “competitive” relation or trade-off between the two most important factors, i.e. between a purchase price that increases budget revenues (a government-agency aim) and investment commitments that would add in the future to the assets of the acquired company (an aim of the managers).

Large and small target companies seemed to behave differently as far as employment commitments to workers to the current management are concerned. The larger a target company was, the less important were employment promises to managers. In turn, the larger a company was, the more important employment commitments to workers proved to be. This is due to the fact that the foreign privatization of smaller companies was usually management-driven, while that of large companies was government-agency driven, and the latter were more interested in employment commitments to the employees than in promising continued employment to managers. No doubt, in the host countries concerned, nobody – neither the trade unions, nor the governments – wanted to see a considerable reduction in employment after an acquisition.

Table 3. Factors leading to a winning bid

Factor	Level of importance (max: 3, min: 1) ^a				
	Czech Republic	Hungary	Slovenia	Poland	Total
(1) Higher purchase price offered	1.6	2.0	3.0	2.0	1.9
(2) Employment commitments ^b	1.4	1.6	2.3	1.7	1.6
(3) Investment commitments	2.1	1.8	2.3	2.6	1.9
(4) Employment commitments to the management of the target company ^c	1.8	1.3	1.3	1.9	1.8

Source: Author's survey.

^a Average scores were derived as follows: (3) very important, (2) important, (1) unimportant.

Correlations:

^b with sales: $r=0.289$ Sig. 040; with total equity: $r=0.287$ Sig. 031.

^c with foreign equity: $r=-.455$ Sig. 005.

A comparison of the countries analyzed demonstrates certain differences. High purchase price was the most important winning factor in Slovenia and Hungary, while in the Czech Republic and Poland the investment commitments played a more decisive role. On the other hand, employment commitments were ranked last in the Czech Republic and Poland, while in Hungary and Slovenia employment commitments to managers took the last place. These differences reflect mostly the differences in sampling – more smaller companies in the Czech and Polish sample, and more larger firms in the Hungarian and Slovenian sample.

The frequency and structure of guarantees and promises given by foreign investors (table 4) by and large confirm the structure of the factors leading to a winning bid. According to the interviewees, strategic foreign investors more or less accepted the conditions – guarantees and promises – imposed by the host country. Among the commitments, future investment guarantees (given in 57 per cent of cases) and best effort investment promises (41 per cent) were much more frequent than employment guarantees (28 per cent) and best-effort employment promises (30 per cent). This structure may reflect a host-country concern about the target companies' restructuring and further development. Both employment and future investment guarantees were positively correlated with the size of the target

Table 4. Guarantees and promises given by the foreign parent company
(Per cent)

Guarantee/promise	Czech Republic	Hungary	Slovenia	Poland	Total
(1) Employment guarantee ^a	31.8	21.4	30.0	28.6	28.4
(2) Best effort employment promise	36.4	28.6	20.0	28.6	29.7
(3) Future investment guarantee ^b	50.0	42.9	30.0	78.6	56.8
(4) Best-effort investment promise	22.7	28.6	50.0	57.1	40.5
(5) Employment promise to the existing managers of the target company ^c	50.0	28.6	70.0	53.6	50.0
Total	100.0 ^d	100.0 ^d	100.0 ^d	100.0 ^d	100.0 ^d
Total number of companies	22	14	10	28	74

Source: Author's survey.

a with sales ($r=0.269$ Sig. 035); with total equity ($r=0.352$ Sig. 003); with foreign equity ($r=0.461$ Sig. 005); with employment ($r=0.312$ Sig. 008).

b with sales ($r=0.338$ Sig. 007); with total equity ($r=0.256$ Sig. 033); with employment ($r=0.320$ Sig. 007).

c with employment ($r=-0.260$ Sig. 030).

d The sum may be higher than 100 per cent because in a number of cases more guarantees/promises have been given.

company, i.e. they were more frequent in larger firms. This may also indicate that the government agencies, which played a decisive role in the case of large privatization transaction, were more successful in negotiating investment and employment guarantees and promises than the target companies' managers were.

The frequency of individual guarantees and promises included in acquisition agreements also indicates that the target companies' managers were more successful in protecting their interests (through employment promises to them or future investment commitments) than workers or trade unions were (through foreign investors' employment commitments). Employment promises to the existing management of a target company were much more frequent (50 per cent of the sample cases) than employment guarantees (28 per cent) or best-effort employment promises to workers (30 per cent). Employment promises to the existing managers were negatively correlated with the target company's size ($r = -0.260$, for the number of employees), i. e. it was more frequent in the smaller than larger acquired companies.

As for the efficacy of investment commitments, U. Korže and M. Simoneti (1992) noted that those were often breached, and that government agencies were usually not in a position to enforce them on the foreign investors, especially when the firms acquired were very large (e.g. FSO-General Motors in Poland and Škoda-Volkswagen in the Czech Republic).⁴

Restructuring in the post-acquisition stage by strategic foreign investors

The foreign acquisition of a company to be privatized not only changes the formal status of the latter but also starts a process of restructuring and adaptation to market conditions. This is, in fact,

⁴ According to the joint venture agreement between Fabryka Samochodow Osbowych (FSO) and General Motors, most of the foreign capital committed to the project had to be invested by GM in a second phase only, after having successfully sold at least 10,000 Opel Astras on the Polish market. From the beginning it was obvious that there were little chances for this condition to be satisfied (Jermakowicz et al., 1995). In the case of Volkswagen's take-over of Skoda, the former's very high future investment commitments played the decisive role in the Government's selection of Volkswagen over Renault. In 1993, Volkswagen considerably reduced its future investment commitments in Skoda. The contract did not foresee any sanctions for such a case (Zemplinerová, 1995).

one of the main reasons for bringing a strategic foreign investor into a company. If the previous owner – the State – would have been able to do that in a satisfactory manner, there would have been no need for such a radical change at all. Bringing FDI into the company is closely related to the expectation that the investor will bring new technology, new management techniques, new accounting standards, and new organizational culture.

Table 5 summarizes the changes and restructuring operations undertaken in the privatized firms after an acquisition. In general, it seems that restructuring was deeper in larger companies than in smaller ones. The new owners most frequently introduced new product lines, reorganized marketing, trained and reorganized the management and financially consolidated the acquired companies. Non-business and/or non-core-business assets of the acquired companies were sold only in 15 per cent of the cases surveyed. This happens more frequently in larger acquired companies ($r=0.295$). One must, however, take into account that, in 27 per cent of the cases surveyed, the government agency or the management had sold some non-core assets prior to selling the firm to the foreign buyer.⁵ Knowing the inherited chronic overstaffing of CEE companies and taking into account that employment guarantees were given in only 28 per cent of the cases, it is more surprising that after the acquisition employment was reduced in no more than 28 per cent of the cases. This, as well, might be linked to the pre-acquisition reduction of overstaffing that had taken place in 37 per cent of the interviewed companies. The methods through which the new owners reduced overstaffing could in most cases be labelled as “soft”, i.e. financial support to early retirement, offering non-(core)-business assets to redundant workers under favourable conditions and then buying their services, retraining of workers etc.

Management training and reorganization were often required because most of the managers were kept (only 22 per cent were replaced) as a result of the employment promises given to managers. It is also true that, in most cases, there were no better alternative local managers available, while bringing management from abroad was usually too costly. As expected, the reorganization and training of the management without changing the managers were most

⁵ Apart from reduction in overstaffing (37 per cent of cases) and sales of non-core assets (27 per cent), the pre-acquisition restructuring activities of the target companies' management or government agencies had also included debt restructuring (23 per cent) and some operational restructuring (16 per cent).

prevalent in smaller acquired companies. (It were in these companies where there had been relatively more employment promises to managers.) The replacement of managers by new ones, trained in parent company headquarters, if any, happened rather in large ($r=0.412$) than in small acquired companies.

As argued, theoretical findings and empirical evidence suggest a beneficial role of FDI in upgrading the host-country's national competitive advantage and, thus, overcoming natural entry barriers to foreign markets. In this context, the host-country actors – in our case the privatization agencies and the target companies' management – appreciated both the potential export performance of the foreign affiliates and the technologies they could transfer. The survey indicated

Table 5. Post-acquisition changes in the acquired companies
(Per cent)

Change/restructuring operation	Czech				Total
	Republic	Hungary	Slovenia	Poland	
(1) Financial consolidation ^a	27.3	42.9	30.0	53.8	40.5
(2) Selling of non-business or non-core-business assets/parts of the company ^b	28.3	7.1	..	14.3	14.9
(3) Reduction of overstaffing	59.1	..	20.0	21.4	28.4
(4) Reorganization of management ^c	31.8	57.1	80.0	46.4	48.6
(5) Replacing members of the management ^d	18.2	21.4	30.0	21.4	21.6
(6) Training of management ^e	54.5	57.1	80.0	67.9	63.5
(7) Introduction of new programs	68.2	28.6	90.0	85.7	70.3
(8) Reorganization of marketing activities	54.5	50.0	60.0	96.4	70.3
(9) Reorganization of supply activities ^f	27.3	21.4	40.0	35.7	31.1
Total	100.0 ^g	100.0 ^g	100.0 ^g	100.0 ^g	100.0 ^g
Total number of companies	22	14	10	28	74

Source: Author's survey.

Correlations:

^a with sales ($r=0.426$ Sig. 001); with total equity ($r=0.271$ Sig. 025); with employment ($r=0.262$ Sig. 031).

^b with sales ($r=0.295$ Sig. 020); with total equity ($r=0.250$ Sig. 037); with employment ($r=0.362$ Sig. 002).

^c with sales ($r=-0.383$ Sig. 002); with total equity ($r=-.299$ Sig. 012); with employment ($r=-.240$ Sig. 045).

^d with sales ($r=0.412$ Sig. 001).

^e with employment ($r=-.332$ Sig. 008).

^f with sales ($r=0.273$ Sig. 032); with employment ($r=0.244$ Sig. 042).

^g The sum may be higher than 100% because in most cases there have been a number of post-acquisition changes/restructuring operations.

that, after privatization, technology was changed in most of the acquired companies. In as many as 80 per cent of the sample cases, the new owners transferred new technology/know-how/products. In 54 per cent of the acquired companies, transfer was in the form of machinery and equipment and in 53 per cent it took the form of industrial property rights, manufacturing, marketing, organizational and managerial know-how and skills, computerization of production, training of management and employees, etc. In most cases (69 per cent), the technology and the product were not just transferred but had been before in some way adapted to the needs of the acquired companies. Additionally, 62 per cent of the acquired companies themselves in which technology/product was transferred further improved and/or developed the transferred technology/product (or intended to do so). Also, 72 per cent of respondents said that there was (or was intended to be) a direct cooperation between the foreign parent and the acquired company in research and development; in 38 per cent of the cases through an exchange of literature and information, in 46 per cent through an exchange of research results, in 46 per cent through a regular exchange of experts, in 23 per cent through an ad hoc exchange of experts and in 34 per cent of the cases in the form of joint research between the foreign parent and the acquired company.

Post-acquisition performance of the acquired companies

The case studies of ten of the companies surveyed confirm and broaden the findings of the questionnaires (Illés, 1995; Jermakowicz *et al.*, 1995; Rojec, 1995; Zemplinerová, 1995). Most of the ten enterprises interviewed had a reasonable level of technological development before acquisition, which made them appealing to foreign investors. However, most of them would find it much more difficult to survive and further develop, or would not survive at all, without a strategic foreign investor, due to the lack of financial resources, new technology and managerial and marketing know-how. The restructuring of the acquired companies usually proceeded relatively smoothly and in a speedy manner. In some cases, strategic foreign investors did not bring dramatic overnight changes but speeded up an already existing restructuring. In any event, foreign partners brought new technology, know-how, finance and the means for the company to gain access to western markets. However, in the early days of restructuring, enterprises were only moderately profitable. Restructuring is time consuming, and a rapid return on

capital cannot be the main motivation for foreign investors. The pace of restructuring depended on a number of factors, mainly the nature of the product and the market structure. Results came faster if restructuring efforts had already been under way before strategic foreign investor became engaged in a company. Also, previous co-operation between the foreign investor and the target company proved to be rather important for the success of the operation.

In the process of company restructuring, the new owners upgraded product quality by changing the production and technological process and by paying more attention to product quality. In general, they improved the production programme and reduced the range of products so as to concentrate on core activities. The foreign investors also tended to change the companies' organizational structure. They considerably increased the training of management and of workers, and set up new systems of accounting and financial reporting complying with international accounting standards. Information gathering and dissemination became more important, especially for competent decision making. A lot of resources were invested into internal information and controlling systems. Managers in general retained their jobs (a very high importance was attributed to the stability of management), but in most cases there was a redundancy of workers. The latter issue was, in principle, resolved by soft methods (enabling workers an early retirement, helping them with establishing their own private business etc.). The role and quality of marketing substantially improved after the takeover, and foreign parents were generally instrumental in introducing environmentally better products and processes. The performance of companies after being acquired was the following:

- Most of the acquired companies (66 per cent) produced the same goods as their foreign parent companies. This, in the first place, confirms that the most prevalent motivation of foreign investors in CEE countries was to supply the local market through local production.⁶ This is further substantiated by a differentiation between stand-alone entities and entities integrated into the foreign parents' networks. Stand-alone entities are frequently horizontal, local-market seeking firms, while integrated entities are frequently vertically organized and

⁶ Access to the local market was by far the most important motivation of foreign investors in the sample firms (on average, it received a score of 2.6 on a scale from 1 to 3). Creating an export base for the CEE region was the second most important motivation (with an average score of 2.3).

export-oriented companies (see, for instance, Markusen, 1995; Lankes and Venables, 1996). As much as 66 per cent of the companies interviewed identified themselves as stand-alone entities and only 34 per cent as being an integral part of their foreign parent companies' network. This has implications for the restructuring of the acquired companies, since foreign parent companies are usually more keen on restructuring and technologically upgrading the firms that are integrated into their network. The efficiency of the integrated firms is more important for the efficiency of the whole network, while it is less so in the case of stand-alone ventures.

- In spite of the prevalence of the local-market-seeking motivation, the export orientation of the acquired companies was quite high. Fifty-three sample companies that answered the respective question, on average exported 49 per cent of their total sales. Larger acquired companies seemed to be more export oriented than smaller ones. Also, larger companies exported relatively more to their foreign parents, which treated them more frequently as an integral part of their international networks, i.e. as producers of goods for other affiliates and for the parent companies.
- A comparison of the production process in the parent company with the production process in its foreign affiliate might be taken as a kind of synthetic indicator of technology transfer. In the case of our sample, the production processes were more or less identical only in 34 per cent of the cases, while in as many as 55 per cent of the cases, the process of the parent was less labour intensive.⁷ The similarity of the production processes was more frequent in Slovenia (in 70 per cent of the sample cases) and Hungary (in 64 per cent of cases). This may be influenced by higher wages in Slovenia and Hungary than in the Czech Republic and Poland, but one should not overlook the fact that the proportion of acquired companies being integrated into foreign parent companies' networks, too, was higher in Slovenia and Hungary.

To what extent do the post-acquisition changes and performance of the acquired companies satisfy the government agencies as sellers and the target companies' management? In the

⁷ In 5.4 per cent the affiliates were more capital intensive than the parents were.

absence of a better measure of meeting the objectives and/or expectations of host-country actors, the target companies' management and the government agencies were asked whether the results of the transactions met their pre-acquisition objectives and expectations. The results are presented in table 6. Although for a number of the sample cases it was quite early to make a definitive evaluation, the results of the survey are rather unambiguous in that the target companies' management is more satisfied with the acquisitions (47 per cent fully and 36 per cent partially) than government agencies, for which in almost half of the cases it was too early to make an evaluation. But if they did make an evaluation it was predominantly in the "fully satisfied" category. In no case have the results of the acquisitions "not at all" met the pre-acquisition objectives of either of the host-country actors. Having in mind that the target companies' survival, restructuring and further development had been key objectives of foreign privatizations on the host-country side, one should not doubt the frequency and scope of restructuring in the acquired companies.

Table 6. Meeting the objectives/expectations of host country actors
(Per cent)

Objective	Czech Republic	Hungary	Slovenia	Poland	Total
(1) Government agency					
(a) Fully	27.3	75.0	100.0	14.3	38.2
(b) Only partially	31.8	12.5	-	7.1	14.7
(c) Not at all	-	-	-	-	-
(d) Too early to evaluate	40.9	12.5	-	78.6	47.1
Total (per cent)	100.0	100.0	100.0	100.0	100.0
Number of answers	22	8	10	28	68
(2) Acquired company/its management					
(a) Fully	36.4	71.4	40.0	46.4	47.3
(b) Only partially	40.1	21.4	60.0	32.1	36.5
(c) Not at all	-	-	-	-	-
(d) Too early to evaluate	22.7	7.1	-	21.4	16.2
Total (per cent)	100.0	100.0	100.0	100.0	100.0
Number of answers	22	14	10	28	74

Source: Author's survey.

Conclusions: how to carry out a successful direct sale

This article has shown that companies privatized via direct sales to strategic foreign investors did, indeed, undergo some restructuring. Nevertheless, the analysis presented here does not provide sufficient insight into the mechanisms of this restructuring process. To put it differently, this analysis does not indicate how this restructuring process would have been if the companies in our sample would have been privatized in some other ways. Some recent studies (Hunya, 2000; Rojec, 2000) however seem to offer a categorical answer to that question. In CEE, foreign affiliates perform (much) better than domestic firms; their return on equity is higher; their export propensity is higher; and they invest more. Even if one compares firms within the same industry, the discrepancies in favour of foreign affiliates remain. This is so, to a large extent, because – compared with companies privatized through other methods (e.g. various investment funds or management/employee buy-outs) – the scope of restructuring in companies privatized to strategic foreign investors has been wider (Simoneti, Rojec and Rems, 1998). Unlike firms privatized through non-sales methods, companies acquired by strategic foreign investors in principle have strong corporate governance, a clear company strategy and better resources (including ownership-specific ones).

It should also to be noted that the present situation of foreign privatization differs from that of the mid-1990s. The main targets of strategic foreign investors are no more the State-owned trading enterprises, but newly privatized companies and State-owned companies in public utilities or financial services. Consequently, the objectives of the new private owners and of the State have changed since the era of mass privatization. The motivation of maximizing the sales price has gained in importance, while restructuring considerations have in a certain sense lost their relevance.

Having recognized these changes, the analysis of the accumulated experience has not lost its relevance. On the contrary, as the number and volume of foreign acquisitions increase and decision-making on the host-country side shifts to new actors, the only way to overcome the lack of practice by new actors is to draw on the lessons from the previous period. This is particularly true when the techniques of how to structure a successful direct sale – be it privatization-related or not – to a strategic foreign investor need to

be learned. In this respect, the host-country actors we interviewed suggested various ways to deal with this question:

- One of the major pre-acquisition issues is whether to restructure a target company before its sale (to a strategic foreign investor) or to leave this to the new owner. It seems that host-country actors could successfully carry out, with little effort and money, a short-term restructuring leading to improved firm values. Long-term restructuring, however, should be carried out by the new owner. The reason for this is that the latter has a long-lasting impact and is always industry-specific. Moreover, in this area, results can only be achieved gradually, by continuous changes in product lines, technology, distribution, sourcing, marketing and information. In fact, if the seller is capable of carrying out long-term restructuring on its own, why does it need to sell the company at all (Boehm and Korže, 1994, pp.13-14)?
- The seller should try to establish competition among potential buyers (strategic investors) through attracting various competitive offers. In principle, it is wrong to start negotiations with only one potential buyer. If there is only one potential buyer, the price will reflect negotiating positions of the parties rather than the real value of the company (especially if the seller is in financial distress).⁸ A competitive and transparent procedure of bidding furthermore will ensure the non-discriminatory treatment of individual potential investors, while achieving the highest possible price for the target company.⁹
- The only way to determine the best price of a company is to have a competitive bidding process. A separate assessment of

⁸ For example, Polish FSO originally started to negotiate its privatization with FIAT (FSO's long-lasting business partner supported by the majority of managers). FIAT made FSO to sign a special "exclusive discussion agreement" which prevented FSO, during the negotiations with FIAT, from contacting any other car producer being potentially interested in FSO. Finally, negotiations with FIAT failed and FSO was partially privatized through a joint-venture agreement with General Motors (Jermakowicz *et al.*, 1995).

⁹ In Estonia, for example, privatization sales to foreign investors were done via international tenders, using the German Treuhandanstalt's model and image. This was important because international investors knew the procedures, could rely on them and felt that they were moving in chartered waters. The Government of Estonia believed that tendering was the best possible public relations approach for the country; created international market transparency for the tendered companies; speeded up decisions through setting fixed deadlines; prevented spontaneous, wild, sometimes criminal, or asset-stripping privatization by management by setting strict tender conditions and procedures; and left restructuring to the market rather than to bureaucrats by selling companies as they were (Dunning and Rojec, 1994).

“fair market value” by an “evaluator” has relatively limited relevance for such a well-executed direct sale. In fact, it is to be expected that the transaction price will be different from the “fair market value” because the buyer will also take into consideration the potential (positive or negative) synergies between the new parent firm and the target company. Hence, the valuation of a company in the direct sale procedure can merely be treated as an indicator or opinion of an “evaluator” of what the approximate floor price of the company should be.¹⁰

- It is better not to disclose the valuation report of the target company to a potential buyer before the end of the negotiations. Such a disclosure necessarily leads to the tying of the offered price to the appraised value of the company. Such a measure causes particularly large damage when and where only one buyer is interested in a company. Any direct sale negotiations, even with only one bidder, should start only after an offer has been placed by the potential buyer.
- The strategic investor normally acquires a majority stake. But in foreign privatizations in CEE countries it has been common for the seller to remain a minority shareholder in the company. The reason for holding a minority stake was, besides reserving shares for a potential employee participation in the equity capital later on, to preclude certain undesirable behaviour by the new owners. The downside of transferring less than 100 per cent of the shares to the new owner is that the latter may be prompted to abuse its position through reallocating/diverting company profits by transfer pricing into a firm in which it is a 100 per cent owner. Then, to safeguard minority shareholder interests and rights, clauses and safeguards on such rights would need to be included in the privatization agreement.
- In principle, a strategic foreign investor wants to be a majority shareholder to ensure control over the target company. It is hence advisable for the seller to put a special premium on the acquisition of a controlling share in a company.¹¹

¹⁰ The experience of the Slovenian Privatization Agency and Development Fund was that, in all direct sales in Slovenia, there was a significant discrepancy between “fair market value” and the transaction price that came out of two to three negotiating rounds (Jašovic, 1993).

¹¹ In this regard, a rather interesting approach was used in the case of Asea Brown Boveri taking over Polish Dolmel. Initially ABB acquired a 40 per cent share. The subsequent increasing of this equity share was linked to increasing Dolmel’s sales to ABB’s parent company (Jermakowicz *et al* , 1995).

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- Foreign buyers often insisted that special privileges be granted to them by governments as part of the deal. Sometimes they required that the government commits itself to do everything in its power to change legislation or economic policy.¹² This should be avoided at all costs. Adherence to the principle of national treatment in the privatization process can be very useful to avoid such demands.
 - Experience speaks in favour of very detailed letters of invitation sent to potential investors. The general structure of the transaction must be introduced in the first step, when the terms of reference and the invitation letters are prepared.
 - The selection of the winning bid is very difficult because proposals are complex and cover various aspects of the target company's operations. Sometimes proposals are practically impossible to compare unless there are some specific guidelines contained in the letter of invitation. It is useful to assign weights beforehand to various aspects of the offer. Macroeconomic implications for job creation, foreign currency revenues, market structure, and fiscal revenues of the government are particularly difficult to assess properly. It is equally difficult to rank two offers where the first promises, for instance, a much higher

¹² According to a letter by Premier P. Pithart to Volkswagen, published in *Lidove Noviny* on 31 May 1991, the Government of the Czech Republic offered the following guarantees to the Škoda-Volkswagen company: (1) Škoda-Volkswagen company was free to set the prices of its products and services; (2) if the foreign equity share reached 30 per cent, the profit tax would be lowered to no more than 40 per cent; (3) according to the decree of the Federal Ministry of Finance No. 586/1990, accelerated depreciation would be allowed for machinery (17 per cent yearly for the first 3 years) and buildings (6 per cent in the first 5 years) purchased after January 1991; (4) covering of the current losses from future profits would be possible during the first 5 years without any limitations or further conditions (tax loss carry forward); (5) the repatriation of the foreign partner's profits abroad in foreign currency was permitted in accordance with the Law on Foreign Currencies No. 528/1990; (6) the Government of the Czech Republic agreed with the State Bank of Czechoslovakia to give the Škoda-Volkswagen company an exemption from the obligatory sale of foreign currency to the State Bank; on the basis of this exception, the Škoda-Volkswagen company was allowed to open an account in foreign currency in any domestic commercial bank (this was an important concession because this allowed the joint venture to avoid the inefficiency of the Czechoslovak domestic banking system); (7) the State Bank agreed to provide permission to the Škoda-Volkswagen company for acquiring credits from foreign banks; the funds acquired this way could be deposited in any domestic commercial bank, as well as branch offices of foreign banks in Czechoslovakia (Zemplerová, 1995).

number of new jobs and the other a much higher purchase price (Korže and Simoneti, 1992).¹³

- A strong negotiating position of the host-country actors needs to be preserved during the final negotiations until the conclusion and signature of the share purchase agreement. After the submission of proposals and two or three rounds of further negotiations, the best offer is selected and an agreement in principle is signed with the winning bidder. Usually at this point not every detail of the future contract has been agreed upon. Experience demonstrates that anything that is left to further negotiations with only one counterpart worsens the bargaining position of the seller. This is why the agreement in principle, which is signed with the potential buyer before declaring it the winning bidder, could be considered the most important document of the bidding procedure. The seller has successfully concluded the most difficult part of the negotiations on contract stipulations, if it has a sufficiently detailed agreement in principle in its pocket. ■

¹³ In all large foreign privatization deals in Slovenia in which the Slovenian Privatization Agency and Development Fund (as the respective government agencies in the field of privatization) were involved, a bidding committee was nominated – composed of the representatives of the Agency and the Fund and of the target company's representatives (management) – which approved the specific criteria for the evaluation of foreign bids and the weight assigned to them. Typically the criteria were structured in the following way: (a) price offered, including the structure of payment: 30 out of 100 points; (b) size and form of immediate additional investments: 20 points; (c) medium- and long-term investments, including technological input: 10 points; (d) employment: 10 points; (e) protection and financial arrangement offered to the minority shareholders: 10 points; (f) financial, market and production status of the buyer: 5 points; and (g) other criteria according to the discretion of the committee: 15 points (Jašovic, 1993).

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Privatization and greenfield FDI in the economic restructuring of Hungary

Miklós Szanyi *

This article compares privatization and greenfield foreign direct investment in Hungary. A rough approach to this differentiation is the fact that foreign direct investment through privatization does not necessarily create new capacities. In a textbook (though not very likely) case, investors do not have to change much in the physical assets they purchased. This is certainly not the case in real life. Yet, the question remains if there are other fundamental differences between these two types of investment. Another important issue in economies in transition is whether their foreign privatization deals differ from other acquisition-type transactions. Could companies have done restructuring on their own, or did they require outside investors? The fact that the insertion of the newly acquired facilities into international corporate networks has required more efforts than in the case of usual merger and acquisition deals elsewhere seems to indicate that foreign privatization has indeed played an exceptional role in economic transformation.

Introduction

The experience of economies in transition with foreign direct investment (FDI) and privatization does not support the view that privatization deals would represent a mere change of ownership, with no contribution to the tangible and intangible assets of the acquired firm and the host economy. Yet, there remain two additional questions to be addressed: Is there a fundamental difference between the two types of investments? Do privatization deals differ from other cross-border mergers and acquisitions (M&As)?

Hungary, as a major and early recipient of both privatization and greenfield FDI among economies in transition, is a good case for comparisons between these two processes and their impact on economic performance. As a consequence of major privatization deals

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and of major greenfield transactions, many Hungarian industries are dominated by foreign affiliates (table 1). This dominance is even more pronounced if we take into consideration that the foreign affiliates are usually controlled by big transnational corporations (TNCs); meanwhile Hungarian-owned firms are often of small and medium size when measured by international standards. While this rather unusual dominance of foreign companies also raises many concerns about the economic (and political) sovereignty of Hungary, that issue is not directly covered in this article (unless the modes of entry for FDI make a difference).

This article is devoted first to differences of motivations of foreign investors in Hungary according to the mode of entry. The approach in that section is based on John H. Dunning's eclectic paradigm (Dunning, 1993). The discussion also covers different types of investors: large TNCs, portfolio investors and investment funds. The question of the similarity between privatization and other M&A type investments is discussed, as are comparisons with greenfield investments. The next section of this article deals with the parallel development of FDI and privatization in Hungary. Then, the article deals with the impact of FDI on the Hungarian economy (restructuring,

Table 1. Share of foreign affiliates in the Hungarian economy, 1999
(Percentage)

	In paid-in capital	In employment	In net sales revenue	Gaps in per capita earnings ^a
Agriculture, forestry, fishing	7.5	4.4	8.9	123.3
Mining and quarrying	34.4	23.9	38.2	111.4
Manufacturing	60.6	46.5	73.0	130.2
Food, beverages and tobacco	60.5	41.5	59.8	136.9
Textile	51.4	36.9	54.7	132.4
Rubber and plastic products	55.6	48.1	57.0	120.7
Machinery	53.8	43.5	55.0	113.1
Electrical machinery	72.1	66.1	88.9	111.8
Transport equipment	74.4	62.8	93.8	113.0
Electricity, gas, steam, water supply	28.1	34.6	51.7	112.1
Construction	29.1	9.8	21.3	196.8
Trade and repairs	43.3	22.6	42.7	189.6
Hotels and restaurants	28.0	19.4	26.8	152.7
Post and telecommunication	67.0	11.7	40.7	200.2
Total	37.9	27.4	50.0	160.7

Source: Central Statistical Office, *Statistical Yearbook of Hungary 2000*.

^a Average earnings in foreign employment as a percentage of earnings in Hungarian employment.

investment, employment, links to international corporate networks, spillover effects and links to other local companies, macro balances). The last part of the article draws conclusions for economic policies.

Motivation of FDI in theory and practice

The most commonly used approach to FDI is Dunning's eclectic paradigm. Much of the empirical evidence on FDI seems to support this theorem because it incorporates many of the characteristics and elements of strategic decision-making of global companies. It reflects correctly the fact that the vast majority of FDI is carried out by large TNCs in global competition.

The empirical surveys of FDI in economies in transition using the framework of the eclectic paradigm focus on the motivations of foreign investors. (For a summary of such literature, see, for example, Szanyi, 1998.) These surveys usually conclude that, in the economies in transition of Central Europe, the availability of locational advantages (opportunities for market penetration, market size, access to production inputs) seems to play a crucial role in the motivation of foreign investors.

The difference of greenfield and privatization FDI is rather obvious in the case of market-seeking motivations. In the case of greenfield FDI, they reflect an ambition to capture a market share. In the same vein, greenfield FDI, if intended to serve domestic and/or regional markets, represents an addition to already existing local facilities in the host economy.

In practice, the market-seeking motivation has manifested itself in Hungary in a strong attempt by TNCs to create footholds in the country. The establishment of sales offices, repair shops and other sales and marketing outlets mounted in the early period of FDI inflows (up to 1995 are examples). The first large greenfield investments in manufacturing started only at the end of this period. A likely reason of this timing was that investors first looked at the supply of would-be privatized companies. Others did not wish to risk large-scale investments in a pioneer project in an economy in transition and rather waited until the economic situation stabilized. After 1995, a new process started to gain momentum: follow-up investments were carried out on a mass scale by traditional suppliers of flagship investors. They settled down in Hungary because of an agglomeration effect.

Close production cooperation simply required that facilities needed to be established in the neighbourhood.

Another frequently mentioned motive for FDI is access to production inputs. In Central and Eastern Europe, this usually means relatively cheap labour (in comparison with its productivity).¹ What is special in Central Europe is the level of education, skills, behaviour and other qualities of the labour force when compared with other emerging regions. From the angle of access to such human resources, greenfield and privatization FDI do not show major differences. Most greenfield investors' primary motive is cheap qualified and productive labour. The high share of outward processing activity in manufacturing greenfield investments clearly shows the importance of this factor. But the same applies for some privatization deals, although here the market- and efficiency-seeking motivations appear combined.

In the Hungarian literature, a useful typology of investor motivations is offered by Bertalan Diczházi (1998). The first type of investment involves the purchase of market shares. Companies, especially in industries that are tightly regulated by production quotas of the European Union, wish to use a Hungarian market presence for their future expansion plans. These companies usually produce basic commodities.

The next type of investment combines market-, efficiency- and asset-seeking motivations. Investors wish to penetrate the Hungarian and the regional market in industries in which market saturation in the developed countries makes expansion there especially expensive and difficult. This type of consideration has been typical in the food, beverages and tobacco industries. Another variant of this type of investor is the firm that develops its regional production, marketing and logistics centre in the acquired Hungarian facility. Not only a domestic market share is an asset here, but also marketing links to other countries of the region (though the existence of such experiences is not a precondition of the investment; sometimes, even if they are present, they are not used by the new owners).

Yet another type of motivation (a variant of asset-seeking FDI) has been to acquire those Hungarian companies that before the transition had already been present on international markets with

¹ In the case of the Commonwealth of Independent States, natural resources also play an important role in the motivation of foreign investors.

their finished or semi-finished goods and had achieved some international reputation. As a substantial part of exports had already been realized in that stage, these Hungarian firms had developed some cooperation with competitors (e.g. through licensing agreements) or had become suppliers of some big TNCs. Once ownership restrictions were lifted, these firms became targets of takeovers. These companies operate mainly in engineering industries, in chemicals and in some light industries (textile, apparel).

As for the comparison between privatization and other M&A deals, there are few differences. Privatization purchases can usually be placed in the broad M&A context as actions to acquire some local production factors and/or market shares. But a few cases apart, privatization deals in Hungary have not been intended to reduce global competition or fundamentally change positions in global competition. Local facilities have been mostly small or medium-sized ones on an international scale. The acquisition of technology and local tacit knowledge has not been typical either. Hungarian firms have not had a leading role in international technological development. This certainly does not mean that local knowledge or engineering skills were not utilized by investors. On the contrary, human resources have in many cases been an unexpected but appreciated addition to the tangible assets that were sold in a privatization deal.

The discovery of additional skills, knowledge and human values means a shift in the locational advantages acquired by an investor. The activities carried out in Hungarian facilities have usually been upgraded rather quickly. Less sophisticated, assembly-type activities have been supplemented by more complicated ones that also produce more added value. Engineering skills have also been increasingly utilized. Large numbers of Hungarian engineers have been hired or employed in the development centres of TNCs. Some companies even moved some research-and-development (R&D) facilities to Hungary. Thus, the country's general experience with FDI shows that the importance of different locally acquired assets may change over time, as does the role and activity of Central European affiliates in global corporate networks.

The role of FDI in privatization has also been strongly influenced by the policies consecutive Government of Hungary adopted to this issue. During this process, the emphasis has shifted several times according to changing political priorities. (See also the article by Peter Mihályi in this issue.)

In Hungary, the establishment of joint ventures was allowed since the early 1980s. Later on, 100 per cent foreign ownership was accepted in selected cases. An act on investment protection was passed in the 1980s. Privatization began on a larger scale in 1988 when a new Company Act was passed, together with the Act on the Transformation of State Enterprises.

To date, the biggest privatization deal has been the sale of first a minority (1993), then a majority stake (1995) in the Hungarian Telecommunication Company (MATÁV) to foreign investors. Paradoxically, it took place when privatization was slowing down. (Only very few medium-sized or large companies were privatized in the period of 1994-1995.²) The rest of the large-scale deals (in banking, electricity, gas and water supply) was carried out after 1995. The shift of privatization sales to services was brought about by two factors. First, most manufacturing facilities were already privatized. Second, the Government of Hungary embarked in 1995 on unprecedented stabilization measures that curtailed consumption and real wages and promoted large-scale investments. The latter were promoted by fiscal incentives and a very favourable regulation of customs free areas (see the article by Katalin Antalóczy and Magdolna Sass in this issue). This, together with the devaluation of the currency and the introduction of an import surcharge, significantly improved Hungary's competitiveness.

Investment incentives can play an additional role in motivating foreign investors. In Hungary, the conditions for such incentives have most easily been met by large greenfield investors. The incentive package as introduced in 1995 supports big investments in special high-technology branches, and in economically depressed regions. Growth and export conditions are also fixed. Privatization FDI is in many cases at a disadvantage, because the modernization and development of existing facilities usually do not reach the threshold value required. In the light of this, perhaps the most powerful Hungarian tool to attract FDI has been the special regulation of customs-free zones available to greenfield investors. Their establishment is simple (see the article by Antalóczy and Sass in this issue).

² First it was the politically motivated mass privatization effort of the Government in the election year of 1994 that slowed down the sales of State property. After the election, it was the new Government that blocked large privatizations for political reasons. In the following years, the same Government changed the path of privatization policy towards a more favourable stance to sales to foreign investors.

Privatization FDI has been supported by other policy measures in Hungary. The privatization policy preferred the sales of State property over free distribution or give-away methods (see the article by Peter Mihályi in this issue). In large deals, usually bids offering the highest (cash) value were selected. This practice obviously favoured foreign (especially large) investors. There were also some privatization deals in which investors could bargain for additional privileges, comparable to the ones enjoyed by greenfield investors.

1998 was the last year during which significant privatization deals took place. A preliminary balance of the Hungarian privatization process is drawn in the article by Mihályi. In brief, FDI has played a significant role, especially in the privatization of big firms (including services suppliers). Small and medium-sized companies were sold either to foreigners or were privatized through management buy-out. Many of the management-buy-out companies were later bought up by others — sometimes by foreign-owned companies.

The changes in policies and in investor motivations resulted in a definite shift in ownership patterns. Early investments usually took the form of a joint venture. The most important rationale behind this was access to the insider knowledge of Hungarian managers. This knowledge was important both for the efficient running of facilities, and for a smooth and beneficial relationship with the local authorities and the Government. As time went by, companies accumulated local knowledge and established direct links to representatives of local authorities, governments and business leaders. The ownership pattern started to change. Joint ventures were replaced by majority foreign ownership, then by 100 per cent foreign ownership. The role of local managers however remained important in the preparation and execution of privatization deals.

The size of investment projects, too, has increased: the period after 1995 saw the establishment and large-scale development of mega investments by IBM Storage, Audi Hungary, Philips, Nokia, Sony and others. After 1997, suppliers of the largest firms followed their partners to Hungary. All these investments were greenfield ones located in customs-free zones. According to Antalóczy (1999), subcontractors move into the free zones either because they change their type of cooperation into regular supplier contracts, or because they start to undertake subcontracting for companies located in customs-free zones. Both possibilities are the result of an improvement in

subcontracting linkages. Suppliers have also other trade links, mainly abroad; thus they are significant exporters as well. Since 1998, FDI has been carried out basically through greenfield investment and the development of existing facilities, both privatized and greenfield. The development and spread of cooperation networks in Hungary indicates that TNCs' presence is not intended to be a short-term episode.

Impacts of privatization and greenfield FDI

Impacts of privatization FDI

In corporate restructuring and modernization (technological level, financial and economic performance, smooth adjustment to the new world economic environment), the micro level adjustment and modernization of privatized companies are fairly well documented (see Szanyi, 1998; Diczházi, 1998; Hunya, 1998). A large number of empirically observed cases in Hungary lets us draw the conclusion that the original expectations as regards firm-level restructuring and modernization, as well as integration into international networks, have been by and large realized. But the process was not without a loss of resources, capacities or competencies. The role that Hungarian companies play in the new cooperation networks is sometimes completely different from what it was before privatization. This applies especially to manufacturing industries that have become large-scale and highly specialized sub-assemblers within international corporate networks, losing their former full scope product range. This type of specialization has been regarded by many managers and observers as a degradation of the former corporate activity.

The picture is, however, more complicated. In the case of market-seeking investments, new owners sometimes intend to change little in the acquired facilities. In a few extreme cases, local production has been stopped and the market is supplied by imports (Diczházi, 1998). In contrast, when market- and efficiency- (cheap labour) seeking motivations are combined, production links to parent companies are not strong, although the affiliates are integrated into international marketing and logistics networks. Established local marketing networks are seen as valuable assets that are further utilized by the new owner. Some product and technology development may occur, especially in industries in which local safety and sanitary standards are lower than the international ones. Sometimes, new

imports from parent firms supplement local production. When investors have regional market-seeking motives, too, they maintain the production of a fairly large number of products that are well established in those regional markets and typically do not change old brands and names. Finally, when the main motivation of foreign investors have been to take over a firm that used to have non-equity links with them, the aim to “internalize” this former traditional supplier and to prevent competitors from acquiring it has typically resulted in improving/maintaining the competitiveness of the acquired firm.

Overall, restructuring and streamlining characterize these investments. Investors maintain and develop only those activities that are relevant to them. This is a normal process in Hungarian companies as well. As Tamás Novák and Miklós Szanyi (1996) have shown, the size and depth of downsizing of former State-owned companies has been similar, regardless of the ownership pattern. A major difference between Hungarian and foreign owners lies in the speed and costs of downsizing. Foreign firms have tended to start and finish basic restructuring as quickly as possible. They have broken up and partly sold large vertical production networks. In contrast, core competencies have been developed to match the highest international standards. This has resulted in vigorous investment activities (Szanyi and Szemplér, 1997). Foreign affiliates have also been faster in creating sizeable new capacities. In the case of such “strategic restructuring”, Hungarian affiliates have become suppliers of other affiliates or other markets as well. The rapid development of activities, discovery and introduction of other local advantages into production are also typical for this group of companies. These “new” local advantages (mainly highly skilled white-collar labour) are usually used in completely new activities. Many of these are moved from developed regions to Hungary. The newly opened R&D facilities of Nokia, Ericsson and General Electric are prime examples.

Many investors who started with privatization FDI carried out development projects costing several times more than what they had paid in the original deal (for example, General Electric in Tungsram). And it was not only the modernization of the acquired facilities that were used as a starting point. Greenfield investments have also been launched by them. Also, some of the privatization investments are in fact close to greenfield investments. In many cases it is only the premises of the company plus labour that were used by the investors. Product, equipment, organization, management, markets – all have been changed.

The above analysis of the type and range of adjustment activity did not mention several organizational, management and communication network developments that were carried out generally by foreign investors, but also in other locally privatized firms. The establishment of up-to-date communication networks and data-processing capacities were the first steps in the adjustment process everywhere. This was a precondition for the installment of new and efficient management practices that use some information technology. The modernization of management also required a reconsideration of the organizational frameworks. This was also rather common. A further widely used adjustment area of corporate functions was in human resources management. Training and education gained importance, and it was also common to hire new top managers for the companies partly from the parent company's staff.

Impact of greenfield FDI

The impact of manufacturing greenfield FDI in Hungary's free zones are analyzed in detail in the article by Antalóczy and Sass. What is important to keep in mind for a comparison with privatization FDI is the paramount interest of foreign investors in a single local advantage: relatively cheap skilled labour (in the case of the former). Also, while there are greenfield investments in other areas of the country and in services too, their impact does not differ radically from those of manufacturing special zones. If there is an important difference between the two, then it is the privilege of the companies in the free zones to import duty-free not only their inputs, but also their machinery and equipment. These firms have quickly become the biggest Hungarian industrial firms producing the highest sales turnover, exports and profits. According to Antalóczy (1999), there is a fairly large and spreading web of close cooperation linkages among greenfield TNCs, and very intensive cooperation and trade links to parent companies. This part of the Hungarian economy has produced the fastest growth, the highest technological level and the most intensive export propensity.

Conclusions and policy relevance

- Without creating basic political and economic stability and a working institutional framework, no FDI and efficient privatization can be expected. The two processes are linked with each other. Their progress can also contribute to an

improvement of the basic economic infrastructure (e.g. banking).

- The motivations of foreign investors are combined differently in privatization and greenfield investments. Market seekers tend to participate more in privatization; resource seekers prefer greenfield investments.
- Although FDI can have strong spillover effects, a spread of supplier networks can not be expected, except if local suppliers match the necessary requirements. If initially this results in a low profitability of supplies, disadvantageous payment conditions, etc., Governments may compensate for such extra expenses.
- Technology spillover effects largely depend on the development level of the recipient. This is not a new phenomenon, but foreign investors may underestimate local capacities from this viewpoint. Foreign affiliates grew in size and scope in Hungary because of a growing use of local skilled labour in more sophisticated activities.
- Privatization (M&A type) and greenfield investments are not plain substitutes for each other. But there may be an important overlap in that investors may consider both options. This happens to companies that combine different motivations.
- Privatization FDI has several sub-categories that behave differently. Market seekers change less in purchased facilities. Resource seekers utilizing local labour tend to introduce fundamental technological changes in the newly acquired facilities. A general overhaul of organization and management, as well as the installation of up-to-date communications and data processing systems, is carried out in every case. These steps result in the immediate improvement of the financial efficiency of companies.
- Greenfield investments usually have very close links to other units in their international corporate networks. Efficiency seeking means in these cases the introduction of the latest production and management systems. A good example for this is just-in-time management, which is applied at the biggest greenfield facilities. Because of the strong cooperation effects, traditional suppliers of large companies may follow their partners with further investments (agglomeration effect).

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- The agglomeration effect became very strong in Hungary. It was even increased artificially through the presence of customs-free zones. A negative side effect is that the spreading of investment becomes more difficult. There are important areas in Hungary in which FDI (at least in manufacturing) does not play an important role. This spatial imbalance is decreasing, as the most popular agglomerations start to show signs of saturation (e.g. lack of labour). The spread of FDI follows highway developments, which is a further evidence of the importance of an adequate level of physical infrastructure.
 - The development of complicated cooperation networks that involve many partners shows that companies have long-term plans as regards their Hungarian facilities. This is an important and promising sign, but it also reflects increased vulnerability. Large TNCs have become active partners of the Government of Hungary. Since every deal needs to benefit the two partners, they support certain Government incentives to increase potential spillover effects (establishment of R&D facilities, development of local supplier network, etc.). On the other hand, much support is provided by the Government to TNCs. The investment support scheme clearly prefers the largest investors, which are TNCs. They also receive individual allowances. ■

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Greenfield investments in Hungary: are they different from privatization FDI?

Katalin Antalóczy and Magdolna Sass*

This article explores the question of whether greenfield foreign direct investment has had a more positive impact on the Hungarian economy than privatization-related foreign direct investment. As far as industry and geographical breakdown is concerned, greenfield investment in Hungary is highly concentrated, more than privatization investment. This article also deals with the special relationship between greenfield investments and export processing zones in manufacturing. This involves a major difference with privatization transactions, which are more embedded in the local economy. The differences between the two modes of entry are also analyzed in terms of employment creation, capital accumulation, technology transfer, competition and productivity, based on the examples of some of the largest greenfield investments in the country. It is interesting to note that, compared with the sum invested, and in comparison with privatization investments, relatively few new jobs have been created by greenfield projects.

Introduction

This article focuses on greenfield foreign direct investment (FDI) in the manufacturing sector of Hungary. However, when relevant information is available, reference is also made to greenfield investments in the services sector. In explaining why firms opt for greenfield projects instead of less costly mergers and acquisitions (M&As), our analysis uses the amended analytical framework of Nam Hoon Kang and Sara Johansson (2000), which differentiates among firm-specific, industry-specific, technology-specific and government- and economic-performance-specific criteria. We have supplemented this basis with other factors and we have tried to relate this framework to the special circumstances prevailing in an economy in transition. For example, technology-specific criteria may favour M&As over

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greenfield investments in global markets; but in an economy in transition, greenfield FDI is still the typical mode of entry for technology leaders. (One exception may be the Hungarian pharmaceutical industry that is dominated by M&As.) Moreover, because relevant capacities may be missing – or it can be difficult to find an appropriate, attractive firm to acquire – greenfield investment may be the only viable option in an economy in transition.

As for government policies, the liberalization of FDI regimes and regulatory reform promote any kind of FDI. Privatization opens up opportunities and increases the availability of favourable M&A targets, which has been the case in many economies in transition. The increase in inward M&As in certain economies in transition has been related to the privatization of state enterprises in certain industries, including public utilities. However, relatively more restrictions on takeovers, particularly on majority M&As, may exist in an economy in transition compared with a developed country. Moreover, the location decision may be influenced by local incentives or subsidies offered by the government, reducing the cost of investment. Sometimes even protected markets (by tariffs, other trade barriers) are offered. This was the case at the beginning of the 1990s in Hungary, for example, in the colour television sets and the vegetable oil industries. Moreover, a host country's incentive system may distinguish between greenfield and other modes of investments, preferring usually the former and thus influence the choice of an investor. This distinction exists in certain economies in transition, sometimes by preferring bigger projects, thus favouring greenfield over other types of investment.

The impact of greenfield investments and M&As on the host economy differ from each other. In some respects differences are of special importance for an economy in transition. By establishing a new plant, greenfield investments lead to greater capacity and contribute to capital accumulation even in the short run. In an economy in transition with substantial investment needs, this is of special importance. However, given the high restructuring needs in such economies, M&As can have similar impacts. Moreover, some M&As may create new capacities later that are comparable to those realized by a greenfield investment. Greenfield investments immediately create new jobs as opposed to M&As, which usually involve a restructuring of the acquired companies. This restructuring is usually coupled with layoffs. In an economy in transition, this is especially true for M&As, because of the high restructuring needs of

(formerly) State-owned enterprises. With the surfacing of unemployment, the job-creating effect can be very important for a economy in transition by reducing the social costs of transition.

Compared with M&As, greenfield investments tend to have a higher tendency to transfer technology, and thus create positive spillovers, the extent of which depends on the absorptive capacity of, and the linkages of the investment with, the host economy. They also transfer various intangible assets. For example, M&As are more prone to transfer managerial and organizational skills. Such assets are badly needed in economies in transition. In such economies, greenfield investments are not necessarily the ones with more spillovers if they remain separated from the host economy. On the other hand, spillovers from M&As, through restructuring, reorganizing, changing a company's activities, and through the linkages of the restructured company with the host economy can be equally significant.

Competition is immediately increased by greenfield investments in a host country by adding new entrants to markets. However, greenfield investment with few linkages to the host economy, concentrating only on exporting, may have a few competition-enhancing effects. This seems to be the case for some export-oriented greenfield investments in economies in transition. The competition-enhancing effects of M&As are more ambiguous; in certain cases they actually decrease the level of competition. They can even serve to eliminate actual or potential competitors. In an economy in transition, protected markets and less developed or not effectively enforced competition rules may make this problem more relevant.

In the case of greenfield investments, several traditional suppliers often also set up local suppliers, thereby enabling the greenfield company to start operating more rapidly in accordance with its own standards. This can affect not only manufacturing but related companies in the services sector as well. Thus, greenfield investments may attract more additional FDI than M&As, but they can be slower in establishing a local supplier network. M&As may retain links with their existing local suppliers, at least at the beginning of their operations, thus attracting less additional FDI; but they have more linkages already at the start with the local economy.

Usually government policies promote greenfield investments because of their bigger immediate positive impact on the host

economy. Thus, higher subsidies to greenfield investments may lead to higher fiscal costs at the beginning. This is especially important in an economy in transition, in which the most important FDI incentives are fiscal ones (besides special regulations or pre-negotiated incentives for big investors), and in which the state of the budget is usually shaky because of transition-related problems and changes. M&As usually enjoy less generous fiscal incentives compared to greenfield investments. Thus their net fiscal impact may be less costly in the short run.

An overview of greenfield FDI in Hungary

Hungary is one of the leading countries among economies in transition in terms of receiving both greenfield and privatization FDI. There are no separate data on greenfield investment in Hungary. According to a survey conducted by the Privatization Research Institute, the total value of greenfield investment in Hungary was \$3.8 billion at the end of 1996, representing 296 projects and 22 per cent of total FDI (table 1). According to the data of the Investment and Trade Development Agency of Hungary (ITDH), greenfield projects accounted for investments of over \$450 million in 1998 alone (with Japanese investors accounting for \$200 million that year), which represented almost one quarter of the total inflow that year. This trend continued in 1999 with investments by Nokia, Temic and Shinwa, among others. One can conclude that greenfield projects now account for an important share of the total FDI stock in Hungary.

Data on industry composition, geographical sources and locational distribution of greenfield investment are also missing. According to a survey conducted by the Privatization Research Institute in 1997, greenfield investment in Hungary was characterised by high industry and locational concentration, relative to privatization investment. This is true in terms of the number of TNCs as well. The main industries of greenfield investment were automobiles, other engineering industries and electronics. (No separate data on greenfield investments in the services sector are available.) The preferred locations of the country were the western counties close to the Austrian border and the surroundings of Budapest. However, in recent years labour shortages have occurred in the more developed western and north-western regions. As a result, greenfield investors have shifted their attention to other locations easily accessible on motorways. Three countries (United States, Germany and Japan) are the leading greenfield investors. Ten big TNCs accounted for half of total greenfield investment in 1996 (table 1). Since then, the number of greenfield

Table 1. Top foreign greenfield manufacturing investors in Hungary, end-1996

Investor	Amount invested (\$ million)	In custom free zone?	Location	Core business	Employees
1. General Motors (United States)	500	Yes	Szentgotthárd	Car assembly, engine manufacturing	900
2. Audi (Germany)	400	Yes	Győr	Car engine manufacturing	1 000
3. Suzuki (Japan)	250	No ^a	Esztergom	Car manufacturing	1 400
4. IBM (United States)	135	Yes	Székesfehérvár	Hard disc manufacturing	1 800
5. Ford (United States)	135	Yes	Székesfehérvár	Car components	1 100
6. Guardian Glass (United States)	110	No	Orosháza	Sheet glass	250
7. Philips (Netherlands)	100	Yes	Székesfehérvár	Electronics	6 000
8. Otto Fuchs Metallwerke (Germany) – Superior International Industries (United States)	75	Yes	Szombathely, Tab, Sávár	Electronics	
9. Coca Cola (United States)	70	No	Tatabánya	Wheel disc	n.a.
10. VAW Aluminium Werke (Germany)	60	Yes	Dunaharaszti	Soft drink	n.a.
11. Tetra Pack (Sweden)	55	No	Győr	Aluminium products	n.a.
12. Schöller (Germany)	50	No	Budaörs	Packaging materials	n.a.
13. K. Nordenia (Germany)	50	No	Törökbalint	Ice cream	300
14. Columbian Chemicals (United States)	40	No	Szada	Plastics	250
15. Stollwerk (Germany)	40	No	Tiszaújváros	Soot production	90
16. ITT Automotive (Germany)	30	No	Székesfehérvár	Confectionery	200
17. Rondo (Austria)	25	No	Veszprém	Car components	750
18. Aga (Sweden)	20	No	Budapest	Paper manufacturing	100
19. Ada (Germany)	20	No	Budapest	Gas production	150
20. Nokia (Finland)	20	No	Körmen	Furniture	220
21. Sony (Japan)	20	Yes	Pécs	Electronics	400
22. Tschibo (Germany)	20	Yes	Godollo	Electronics	200
23. United Technologies Automotive (United States)	20	No	Budaörs	Coffee	120
24. Weisheimer Malzfabrik (Germany)	20	Yes	Godollo	Car components	1 000
25. Ericsson (Sweden)	20	No	Dunaújváros	Malt production	20
26. Pioneer H. Bred (United States)	20	No	Budapest	Telephone	500
		No	Szarvas	Fodder production	n.a.

Source: Unpublished data provided by the Privatization Research Institute, Budapest, Hungary.

^a 1990-1995: yes.

investors has grown rapidly, and in recent years this mode of entry appeared to be dominating.

The choice between greenfield investment and M&A for an investor investing in Hungary is influenced by the same factors listed in the first part of this article. However, there are some factors that influence this choice more strongly. Greenfield investments are more characteristic of the machinery industry (automotive, electronics), due to industry specific and technology related aspects; and of some light manufacturing industries, especially clothing, due to managerial-organizational aspects, and location decisions based on inexpensive, relatively skilled labour. Domestic market oriented investors usually choose M&As as the mode of entry as knowledge about the market matters; greenfield investments are usually more export oriented.

Company-specific aspects may also play a role. Established distribution networks, brand names, market shares and market knowledge are important attracting factors for domestic or regional market-oriented investors, which may induce them to seek a partner for M&As.

Technology-related aspects play a role, especially because labour-intensive processes in certain machinery segments can be separated from the overall production process and transferred to a low-wage location, in that case to Hungary, usually through the establishment of a greenfield investment – given the lack of suitable existing capacities. On the other hand, in some cases and industries that had a relatively developed technology at the beginning of the transition process, acquiring technology could also have played a role (e.g. some pharmaceutical companies and Tungram). This latter factor favours M&As (privatization).

Government policy influenced the choice of investors in different ways. In the framework of privatization, attractive companies were offered to foreigners as M&A targets (see the next article). In the first years, even monopoly positions or protected markets were offered to foreign investors (both greenfield and M&As). Overall, these factors induced foreign investors to prefer M&As to greenfield investments. In the second half of the 1990s, with less left to privatize, with more incentives to big (greenfield) investors and a more stable economic environment, the number of greenfield projects started to grow. The economic performance of the country, and the fact that Hungary made the most progress among the economies in transition towards becoming a full market economy attracted all kinds of FDI.

The integration policy of the Government attracts both types of investments. Future European Union (EU) membership – and thus access to the EU market – however favours more greenfield investments in certain industries given the relatively low cost of skilled labour, scale economies, new technology and the immediate access to a market with high demand.

Greenfield investment and industrial free trade zones

The unusually high proportion of greenfield investment in total FDI in a regional comparison can be explained by the special regulation of industrial free trade zones (IFTZs). IFTZs were introduced first in 1982 with the objective of attracting export-oriented, high-technology FDI to Hungary. International examples of similar schemes can be found in the export processing zones of developing countries and the customs free zones of Ireland and the United States. At the same time, another objective was to integrate the companies operating in IFTZs as much as possible into the host economy, to reduce the risk of a dual economy evolving.

The regulation of IFTZs is unique in Hungary. Any company may set up, under license by the customs and finance authorities, its own zone in any area inside the country without geographical restrictions. IFTZs are considered to be extra-territorial for the purposes of duties, foreign exchange and other legislation. The dutiable goods and means of production (excluding building and auxiliary material) are not subject to customs duties and value-added tax.

Why is that regulation especially attractive for (export-oriented) greenfield investors? Since 1996, in-kind contributions can be transferred to the country duty- and VAT-free only for investments realized in IFTZs. For these large investments, paying duties and VAT would mean high additional costs. (It is important to note that, in the EU, investment goods can be imported duty free.) Another reason for the growing number of companies in IFTZs is that, in line with the regulation of IFTZs, companies operating there can buy their inputs from the domestic economy with a special permission and up to a certain amount only. Thus, their traditional suppliers following them to Hungary establish their affiliates in IFTZs as well, which results in a growing number of companies in these special zones. Moreover, companies operating in an IFTZ do not face a currency risk, because they can keep their accounts in a foreign currency.

Starting from 1990, more and more IFTZs have been established in Hungary. First, a number of large TNCs carried out greenfield investment in Hungary in an IFTZ (for example General Motors, Suzuki, and Philips). Later their competitors or suppliers followed them and established their Hungarian affiliates in an IFTZ (Ford, Audi, IBM, Nokia, LEAR Corp., United Technologies, Sony, Zollner), as well as a few companies that identified Central and Eastern Europe as an attractive investment location around that time (like Benetton).

At the end of 1999, 115 IFTZs existed in Hungary, operated by 101 companies. Philips (computer monitors, telecommunication products) operates more than one IFTZ, as well as the LEAR Corp. (car seats, other car parts). According to our estimates, based on company interviews, of the 115 IFTZs in Hungary, about 70-75 were established through greenfield investment. The share of foreign capital exceeds 90 per cent in all the base capital of IFTZ companies.

As for the prospects of IFTZs in Hungary, gradual import liberalization has diminished the attractiveness of duty-free treatment for many companies operating in an IFTZ. There would be still 10-15 companies for which the maintenance of special regulations would remain important after the country joins the EU, because they import or export large proportions of their inputs or outputs from or to outside preferential trade areas (EU, Central European Free Trade Area).

Impact on the Hungarian economy

This article does not cover the impact of greenfield FDI in services, due to the lack of relevant information. As for manufacturing, usually there are important differences between greenfield investments and M&As. However, on the basis of company interviews, it is apparent, at least for Hungary, that making a distinction between the two modes of investments in terms of their impact on the host economy is not so clear-cut. In many cases, foreign investors who acquire a Hungarian company in the framework of privatization carry out investments and restructure as much as in a greenfield investment. In most of the cases, the physical establishment of a plant itself needs such extensive further investment and development, which sometimes involve the total scrapping of previous machinery and even buildings, which can be compared to the effect of greenfield investments in developed or developing economies. Moreover, after the rebuilding and renovation of the existing plant and the installation of new

machinery, the company profile, product structure and size of the output may have completely changed.

The examples of Knorr-Bremse (box 1) and Nokia (box 2) are instructive in this respect. These examples also reflect one specificity characterizing economies in transition: capacities acquired by foreign investors in some cases are obsolete and need complete restructuring. Thus the foreign investors, who decide to choose M&As as a mode of entry, carry out changes and developments that are comparable to those of greenfield investments.

Box 1. Knorr-Bremse: joint venture, privatization and the overall restructuring of production

In the second half of the 1980s, the German company Knorr-Bremse set up a joint venture with the Hungarian MOGURT Foreign Trade Company at the Kecskemét (East-Central Hungary) plant of a Hungarian equipment manufacturer. The joint venture exported brake systems for buses and trucks produced by other countries of the Council for Mutual Economic Assistance (CMEA). The aim of Knorr-Bremse at that time was to get access to the large CMEA market. After the collapse of the CMEA, this market shrank significantly. At the beginning of the 1990s, Knorr-Bremse changed its strategy and bought out the shares of the co-owners of the joint venture. The Kecskemét plant began to produce the brake systems of the parent company, which were completed in Germany at the parent company's plant and then exported to major vehicle manufacturers. The completely new production (from the point of view of both quality and quantity) required massive investments, which were carried out by the parent company from 1994 onwards. The former, CMEA-oriented capacities were closed down and disposed of, the plant was restructured and new buildings were erected. Complete production systems, new technology and quality systems were transferred from Germany to Hungary. In order to decrease the costs of the investments, the company transferred its production to an IFTZ, and thus did not have to pay the value-added tax and duties on the imported equipment. The total output of the company grew five-fold in nominal terms between 1994 and 1998, and the number of employees doubled. The company bought another plant in Budapest, which was also completely renovated and restructured, and transferred the European R&D base of one of its products to that location.

Source: information compiled by the authors.

In other cases, the actual investment does not strictly correspond to the definition of a greenfield investment (i.e. starting the investment from scratch), while in reality it bears all the characteristics of it. The reason for that may be that the investing company acquires the empty production hall or empty buildings from a local company (e.g. Nokia's case in box 2, or Benetton's in box 4). Moreover, it can happen that, in a joint venture formed by a local company and the investor, the contribution of the local company is a building or a physical establishment, the value of which is negligible compared to the development and investment financed and carried out by the investor afterwards. On the basis of company interviews, this has happened in the case of a few greenfield investments in Hungary.

The role of the industrial free trade zones in the Hungarian economy

Because no systematic data on greenfield investment in Hungary are available, and as we have seen there is an overlap between *manufacturing* greenfield investment and IFTZs, we will partly trace the impact of greenfield investment on the Hungarian economy

Box 2. Nokia: change of profile and development after a secondary privatisation

The Pécs-based (southern Hungary) company of Mechlabor, which was established for military production purposes in 1978 and produced microelectronic equipment for the (former) Soviet and Middle-Eastern markets, went bankrupt in 1989. After the liquidation, an Italian company, Hantarex acquired it. The company began to produce computer monitors for the Olivetti and Compaq, using a relatively unsophisticated technology. The Italian parent company went bankrupt and wanted to sell its Pécs affiliate. In 1995, Nokia bought the Pécs company. In reality, this meant only acquiring an empty building, a fact reflected in the actual purchase price paid by Nokia, which was less than one-third of the amount it invested into it between 1995 and 1999. Production systems were transferred to Pécs (their number has grown from 14 in 1997 to 28 in 1999), a new warehouse was built, and a new quality control system was introduced. The number of employees went up from 750 in 1995 to 1,830 in 1999.

Source: information compiled by the authors.

through IFTZs. However, there are some limits to this approach. These zones contain only export-oriented firms eligible for duty-free status that operate in the manufacturing sector. They do not contain domestic market oriented manufacturing and services sector greenfield investment. (However, on the basis of company interviews, it is apparent that, until recently and with the appearance of big shopping malls, the share of the latter in total greenfield investments was relatively small.)

According to a survey conducted for the period 1994-1996 by ECOSTAT (a Hungarian research institute under the auspices of the Statistical Office) (ECOSTAT, 1997), IFTZs played a determining role in the Hungarian economy. Without their activities, in the years reviewed, the growth of the volume of industrial production would have been 2 to 4 percentage points lower. Through the new capacities they created, they contributed significantly to overall investment and production in the manufacturing sector. In some sectors, the new capacities increased competition. During the period analyzed, IFTZs dynamically increased their net sales, output, export, pre-tax profits and gross value added. Their performance indicators were on average 3 to 4 percentage points higher than those of their non-IFTZ counterparts were.

New jobs were created by greenfield investment in IFTZs. The number of employees in IFTZs doubled between 1996 and 1998 and now represents one per cent of all employees and close to 6 per cent of the employees in the manufacturing sector. To illustrate the role of IFTZs in the labour market, it can be mentioned that, in those regions in which the majority of the IFTZs can be found, there is a shortage of certain skills. The average wages of employees in IFTZs were 40 per cent higher and their productivity more than double compared to those of their counterparts in the domestic economy.

The competition enhancing effect of IFTZs are less straightforward. At the beginning, they had very little linkages with the domestic economy. In some cases, even though firms were operating in an IFTZ, they could export to Hungary duty free and could access a protected market. However, in the second half of the 1990s, linkages with the host economy became more significant and trade policy measures no longer separated them from import competition. The role of the IFTZs in the Hungarian economy increased further in importance in 1998-1999.

Exports from greenfield FDI projects

The importance of greenfield FDI in foreign trade can also be traced through the activities of IFTZs. On the basis of a questionnaire survey, it can be concluded that greenfield investments are usually more export oriented, while privatized companies are more domestic market oriented (Éltető and Sass, 1997).

Due mainly to the activities and functioning of companies based in IFTZs, Hungarian exports grew rapidly during the second half of the 1990s and underwent significant changes in the product and partner composition (tables 2, 3 and 4). More specifically, 2000 companies in IFTZs carried out more than 44 per cent of Hungarian exports, and they are responsible for 31 per cent of total imports (table 2).

During the first half of the 1990s (the first period of their functioning), IFTZ companies mainly worsened the trade balance through their imports of high-value machinery and inputs. However, during the second half of the 1990s, when their production became more established and there was a change in the regulation of the

Table 2. The share of industrial free trade zones in Hungarian foreign trade, 1996-2000
(Per cent)

Item	1996	1997	1998	1999	2000
Exports	18.1	26.6	36.0	43.0	44.7
Imports	13.9	19.8	25.2	30.6	31.4

Source: data provided by the Ministry of Economic Affairs of Hungary.

Table 3. The foreign trade balance of Hungary, 1996-2000
(Million dollars)

Type of balance	1996	1997	1998	1999	2000
Balance of non-IFTZs	- 2 758	- 2 966	- 4 503	- 5 188	- 5 925
Balance of IFTZs	+ 318	+ 832	+ 1 802	+ 2 192	+ 2 595
Overall trade balance	- 2 440	- 2 134	- 2 134	- 2 996	- 3 330

Source: data provided by the Ministry of Economic Affairs of Hungary.

treatment of in-kind contributions in IFTZs, they became net exporters, with an increasing positive trade balance (table 3). In particular, companies in IFTZs are responsible for the dynamic growth of the export of machinery and equipment during the second half of the 1990s. Machinery and equipment in 2000 represented almost 60 per cent of total exports, while the share of this product group was 36 per cent in 1996 (table 4).

The role of greenfield companies operating in IFTZs in Hungarian exports is clear on the basis of table 2 in the article by Peter Mihályi in this issue. Of the top ten exporting companies, five (the ones marked with IFTZ) operated in IFTZs in 1998. All five had been established through greenfield investment.

According to the list of the top ten Hungarian export products in 1999 (table 5), which represent 35 per cent of total exports, the role of greenfield investments operating in IFTZs is also dominant. According to the above data, the role of IFTZs (and thus greenfield investments) is determining from the point of view of the development of Hungary's foreign trade. Nine of the ten products belong to the machinery and equipment group.

Greenfield FDI and technology transfer

There are no data or surveys on the technology effect of FDI in Hungary. Some studies analyze the research and development (R&D) activities of companies with foreign participation. Surveys show that the R&D intensity of companies with foreign participation is much higher than that of domestic companies; also R&D expenditures are growing much faster in the first group of companies (Inzelt, 1998; Szalavetz, 1999).

Table 4. The product structure of Hungarian exports, 1996-2000
(Per cent)

Item	1996	1997	1998	1999	2000
Food, beverages, tobacco	15.2	12.9	10.5	8.0	6.9
Raw materials	4.4	3.8	2.9	2.5	2.4
Energy	3.3	2.7	1.9	1.6	1.8
Manufactured products	40.8	35.5	32.7	30.7	29.1
Machinery, equipment	36.3	45.1	52.0	57.2	59.8
Total	100.0	100.0	100.0	100.0	100.0

Source: data provided by the Ministry of Economic Affairs of Hungary.

The technology transfer effects of greenfield investments in Hungary are not documented. As an indirect approach, one can have a look at changes in the export structure by analyzing some characteristics of the top ten export products of Hungary in 1999 (table 6). In 1999, four of the top ten export products belonged to the high-technology category, using the classification of the Organisation for Economic Co-operation and Development (OECD). They are all “newcomers” on the list of the top ten export products, as is apparent from their negligible share (less than one per cent) in total exports in 1992. Companies operating in IFTZs produce them all, and three of these are greenfield investors; and greenfield investment projects as well as joint ventures and domestic companies produce the fourth high technology export product.

Analyzing total exports, the share of high-technology products has been growing significantly in the second half of the 1990s. This process resulted in an almost 19 per cent share of high-technology

Table 5. The top ten Hungarian export products in 1999

SITC	Product	Value of exports (thousand dollars)	Share in total Hungarian exports (Per cent)	Exporting company with foreign participation?	Green-field Invest-ment?	In industrial free trade zone?
71322	Reciprocating piston engines	2 183 289	8.7	Yes	Yes	Yes
7527	Storage units (computers)	1 544 351	6.2	Yes	Yes	Yes
7812	Motor vehicles for the transport of persons	1 342 758	5.4	Yes	Yes	Partly
75997	Parts, accessories for automatic data processing machines	1 094 039	4.4	Partly	Partly	Yes
76381	Video recording or reproducing apparatus	679 559	2.7	Yes	Yes	Yes
7526	Input or output units	668 901	2.7	Partly	Yes	Yes
7611	Television receivers	378 129	1.5	Yes	Yes	Partly
82119	Parts of seats for motor vehicles for the transport of persons	357 403	1.4	Yes	Yes	Yes
71323	Compression-ignition engines	316 006	1.3	Yes	Yes	Yes
78439	Other parts for motor vehicles for the transport of persons	314 484	1.3	Partly	Partly	Partly

Source: authors' calculations based on OECD foreign trade data.

products (in SITC) and a more than 24 per cent share of high-technology industries (in ISIC) in Hungarian exports by 1999. The corresponding shares were 3 per cent and 7 per cent in 1992.

From company interviews it is apparent that in some cases the export of high-technology products is based on simple assembly operations, in which the local value added is only inexpensive labour. In some other cases, high-technology products are produced with significant local input, and more and more companies are transferring some or all of their R&D activities to Hungary (e.g. Audi, Nokia, General Electric, Knorr-Bremse, ABB, Ericsson and Sanofi).

Linkages of greenfield FDI

There are differences in local value added and the use of local suppliers according to the type of investment in Hungary (Sass, 1996). Understandably, some of the privatized companies retained their original domestic suppliers after restructuring, particularly if their main focus is on the domestic market. For example, in the case of General Electric-Tungsram, at present, the share of local suppliers is over 60 per cent. A similar high local share is characteristic of companies with foreign participation in the food industry.

Table 6. High-technology products among the top ten export products of Hungary, 1999

SITC	Product	High-technology product?	Share in exports in 1992 (Per cent)
71322	Reciprocating piston engines	No	0.0
7527	Storage units (computers)	Yes	0.0
7812	Motor vehicles for the transport of persons	No	0.2
75997	Parts, accessories for automatic data processing machines	Yes	0.1
76381	Video recording or reproducing apparatus	Yes	0.1
7526	Input or output units	Yes	0.0
7611	Television receivers	No	0.2
82119	Parts of seats for motor vehicles for the transport of persons	No	0.1
71323	Compression-ignition engines	No	0.1
78439	Other parts for motor vehicles for the transport of persons	No	0.1

Source: authors' calculations based on the OECD FTS database.

On the other hand, it can take a considerable time to build up a local network of suppliers in the case of greenfield investments. Many greenfield investors have a limited number of local suppliers, but, in most cases, there has been an increase as the company has become established over time. (See for example box 3 on the automotive industry.) The share of local suppliers in total inputs is below 10 per cent in the case of the Hungarian Philips and Sony affiliates.

As Japanese and United States investments are mainly oriented towards the EU or the Central European Free Trade Area, they tend to use more local suppliers than EU investors in order to achieve the local content level required for preferential tariff treatment. A good example of that is the Suzuki affiliate, which has built up a network of local suppliers very quickly, offering in some cases extensive and generous help (including free access to technologies) to local companies.

On an industry basis, the automotive, electronics and chemical industries have a high proportion of domestic suppliers worldwide. In Hungary, greenfield investors have in the automotive and electronics industries built up their networks slowly. However, in the chemical (pharmaceutical) and food industries, dominated by M&As, higher-than-average domestic linkages are characteristic in Hungary as well.

Due to their regulation, firms in IFTZs are less prone to build up local supplier networks. However, a gradual increase in local value added is reflected in the fact that, compared to 15 per cent in 1997, 21 per cent of the total supplies of companies operating in IFTZs in 1998 were sourced from 2,500-3,000 Hungarian manufacturers, according to the data of the Ministry of Economic Affairs.

In addition to small and medium-sized Hungarian suppliers, some former large State-owned companies, such as Bakony Müvek Rt. and Videoton were able to survive by becoming suppliers to TNCs with production capacities in Hungary. For example, Videoton supplies the Hungary-based affiliates of GE-Tungstam, IBM, Knorr-Bremse, ABB, Matsushita, Philips, and Sony, among others.

The car industry in Hungary is characterized by greenfield investment. The changes in the car manufacturers' local value added are a good illustration of how greenfield companies build up gradually their local supplier networks (box 3). Hungarian companies can usually

link up with those traditional suppliers of the greenfield investors that followed their partners to Hungary.

Box 3. Domestic suppliers of the four car producers in Hungary

The TNCs that invested into the Hungarian automotive industry have developed many linkages with the domestic economy. At present, about 250 local companies supply parts and components to the companies in the automotive industry. This must be considered in the light of the fact that most of these affiliate companies operate in IFTZs, and thus are less inclined to use local (outside IFTZ) suppliers. The shares of local suppliers in total inputs vary across the four automotive companies. At present, in the case of Opel and Audi, they remain below 5 per cent. The other extreme is represented by Suzuki, which has a network of over 40 suppliers, and an overall local value-added of 53 per cent. Indirectly, Suzuki's role is even greater as many companies that were able to supply Suzuki with spare parts and components also became suppliers to other automotive companies. For example, the Hungarian Kunplast company supplies both Suzuki and three other automotive companies (BMW, Ford, Opel). The Székesfehérvár company of Ford falls between the two extremes: the share of local suppliers is estimated to be about 20 per cent.

The gradual increase is indicated by the fact that these shares were in most cases significantly lower than three years ago. Thus, in the case of Opel and Ford, the share of local suppliers was about 8 per cent, and for Audi it remained below 1 per cent. In the case of Suzuki, the share of local suppliers slightly exceeded 30 per cent. Local suppliers can be domestic Hungarian companies, but in most of the cases they are foreign suppliers that have followed the automotive investors to Hungary and supply their customers through joint ventures or greenfield operations. This approach was adopted by many first-tier suppliers such as VAW (aluminium car parts), Lear Seating (car seats) and Peguform (plastic car components), which followed Audi to Hungary. Other examples here are Knorr-Bremse and Denso. According to a survey, about half of the small and medium-sized companies producing parts and components for the automotive industry in Hungary are in majority foreign ownership. Many Hungarian companies can link up with these first-tier suppliers and become part of the extended supply chain of the big automotive companies operating locally.

Source: OECD, 2000.

Company strategy and product characteristics also influence the decision of an affiliate as to whether to rely more or less on local suppliers. As a result, some greenfield sites can have extensive local linkages (see the cases of Benetton and Knorr-Bremse in box 4).¹ As we saw in box 1, after the change in the strategy of the parent company, the Knorr-Bremse affiliate invested and changed the structure of production; the extent of these changes is comparable to a greenfield investment. The Hungarian affiliate started out with a very low share of local suppliers. After the total restructuring of the company, with investments more characteristic of a greenfield company, the company increased the share of local input considerably. These two companies have relatively extensive local linkages.

Box 4. Two exceptions with extensive local linkages: Benetton and Knorr-Bremse

The Hungarian affiliate of the Italian Benetton company relies on domestic suppliers to a greater extent than other companies in IFTZs. This is understandable on the basis of the business philosophy and organizational structure of the company. At present, the affiliate uses 20 Hungarian sewing plants and is continuously looking for other Hungarian suppliers. Benetton concludes a one-year contract with its subcontractors, and its technicians train their employees. These small plants are only allowed to work for the Benetton affiliate. The Hungarian affiliate's aim is to increase Hungarian value added. It has already found the supplier of packaging materials and is looking for suppliers of base materials (tissues, cotton) and of granulate. If the Hungarian affiliate succeeds in building up a local supplier network, it can be the Central and Eastern European production, logistics and commercial centre of Benetton. The IFTZ regulation may act as a barrier in that case; that is why the company has already applied for a permit that would allow it to buy inputs from non-IFTZ companies.

Knorr-Bremse deployed its own, traditional suppliers at the beginning of the change of the company strategy concerning its Hungarian affiliate; but in order to reduce costs, it tried to find more and more local (Hungarian and neighbouring country) suppliers. In 1994, the share of local suppliers was 18 per cent, which went up to 50 per cent by 1998.

Source: information compiled by the authors.

¹ In our view, the Hungarian Benetton affiliate can be considered as a greenfield investment. (The company bought only empty production halls.)

Greenfield FDI and associated investment

One of the important impacts of greenfield investments on the host economy is that usually they induce their traditional suppliers to follow them to their new investment location, thus helping the country to attract more FDI. Box 3 also calls the attention to that important feature of greenfield companies in Hungary. Through their presence and need for suitable inputs, parts and accessories for producing for exports, they can induce their traditional suppliers to follow them to Hungary. These “followers” set up a company, either through a greenfield investment or through finding a suitable local partner company for M&A. This FDI enhancing effect of greenfield investment is apparent in Hungary.

Conclusions

A significant part of total FDI is greenfield investment in Hungary. (No separate data on greenfield investments exist.) Concerning the impact of this investment on the economy, some of the privatization or joint venture FDI has effects similar to those of greenfield investment, in terms of establishing new capacities, upgrading technology, changing the product structure, etc. Thus, it is not easy to separate the effect of greenfield investments from privatization and other FDI.

This article has concentrated on four areas in which the impact of greenfield investment on the host economy can be traced on the basis of data or industry/company surveys or interviews. We have tried to analyze effects on exports, technological development, linkages and attracting FDI.

The effect of greenfield investments on the Hungarian economy can be traced through the performance of IFTZs. There is an overlap between the two. On the basis of company interviews, of the 115 companies operating in an IFTZ, 70-75 companies are greenfield. An analysis of IFTZs shows the important role that these zones play in determining the performance of the Hungarian economy, especially in the case of foreign trade. In particular, the growth of exports and changes in its production structure can be mainly attributed to TNCs’ greenfield investments in IFTZs. However, at present these companies have limited linkages to the host economy,

and thus their effects on the overall economic performance may be limited. Nevertheless, there are signs that local supplier networks are gradually being built, and that there is an increase in local value added and in the use of more skilled local labour. Greenfield investments in IFTZs have encouraged their traditional suppliers to follow them to Hungary. These companies have set up a greenfield company or have established joint ventures in IFTZs as well, adding to the stock of FDI in Hungary. ■

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The evolution of Hungary's approach to FDI in post-communist privatization

Peter Mihályi*

This article investigates how Hungary has become a success case of post-communist privatization. It argues that, by emphasizing macroeconomic stabilization and fast formal ownership change more than a quest for real owners, policy makers in the East and the West have for many years misunderstood the *raison d'être* of privatization. Hungary has done things differently because it had been forced from the very beginning to divest its State-owned enterprises against hard currency. For many policy makers this was a painful and regrettable step. It was only around the mid-1990s that Hungarian privatization officials understood that selling virtually each and every “crown jewel” of the Hungarian economy to transnational corporations was a blessing in disguise. This was the only conceivable way to put Hungary firmly on an export-led growth path – something that Hungarian policy makers had urged in vain for two decades. Other policy makers have understood this connection only recently. This article revisits the post-communist privatization process from this perspective, and highlights the importance of access to corporate networks.

Introduction

Today, it is widely accepted that Hungary has accomplished post-communist privatization successfully. This article however does *not* address the issue of success from a comparative perspective (whether and to what degree Hungary has been or has not been more successful than other countries). The main message of this article is that success in Hungary has not been the result of deliberate policy intentions to maximize the role of foreign direct investment (FDI) in privatization. To the contrary, by emphasizing de-etatization and certain aspects of corporate governance, policy makers in the East

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and the West (Hungary included) for many years misunderstood the *raison d'être* of privatization, and had a distorted idea of where the priorities should be (Mihályi, 2000).

Hungary has done things differently because it had been forced from the very beginning to divest its most valuable State-owned enterprises (SOEs) against hard currency. For many policy makers – let alone politicians – this was a painful and regrettable step. It was only around 1994-1995, when Hungarian privatization officials understood that selling virtually each and every “crown jewel” of the Hungarian economy to TNCs was a blessing in disguise. This was the only conceivable way to put Hungary firmly on an export-led growth path – something that Hungarian policy makers had urged in vain in the 1970s and 1980s. Other policy makers have understood this connection only recently.

This article re-interprets the post-communist privatization process in the context of globalization. An attempt is made to fit this story into a worldwide perspective. Subsequent sections will discuss the origins of the Hungarian approach to privatization, the re-interpretation of the Hungarian privatization story as such, while the last part looks at the results of privatization from the point of view of export performance.

The origins of the Hungarian approach to privatization

In the transition from socialism to a Western-type market economy, the first aim of privatization was to eliminate the inherent inefficiencies of social ownership and planning. In the early 1990s, it was argued that replacing bureaucratic incentives with profit-oriented ones at the company level would lead to increased *production efficiency* (Blommestein *et al.*, 1991, p. 12). The interpretation of privatization, however, could not be limited to the firm level only. Priority had to be given to legal reforms, too, as ownership, competition, together with competition, the regulatory environment, macroeconomic stabilization and trade liberalization had interrelated influences on *allocative efficiency* (Brabant, 1992). In this model, FDI was not expected to play a key role in privatization.

A handful of commentators nevertheless mentioned three reasons for the involvement of transnational corporations (TNCs) in privatization from the outset (e.g. Mádi, 1995):

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- the capital stock gap;
 - the technology gap; and
 - the lack of entrepreneurship.

At the beginning of economic transition, the situation in Hungary was not fundamentally different from that of any other Central and Eastern European country. However, due to some particular characteristics of the Hungarian political and economic landscape, such as the high level of foreign debt, the existence of joint ventures, and the early start of cooperation with Western banks and multilateral institutions, successive Governments were forced to steer privatization in a direction that explicitly favoured TNCs.

Right before and after the first democratic elections of 1990, Hungarian politician had to find answers to two pressing questions:

- What to do with the country's accumulated \$20 billion gross debt?
- Was re-privatization (or restitution) a possible avenue towards the rapid divestment of State assets?

The representatives of TNCs already present in Hungary heavily influenced the answers to both questions. Although their investment until 1990 had not exceeded \$500 million, and they had stakes in less than 100 joint ventures, they were influential Western companies: Girozentrale, Siemens, Adidas, Volvo, Ikea, Citibank, Société Générale, Creditanstalt, etc. (Mihályi, 1993). The voice of the international financial community – including the Bretton Woods institutions¹ and foreign private banks – was also important.

If Hungary defaulted on its debt, it was argued, the short-term implications on the exchange rate would question the economic rationale of all foreign investments made so far. Additionally, a privatization policy with a significant restitution component might question retroactively the legality of these investments. On top of that, elementary calculations showed that the two issues – i.e. debt management and privatization – were closely interrelated. If Hungary decided to keep servicing its foreign debt fully, that was not possible without FDI inflows in the order of \$1-2 billion per annum. In this logic, any attempt to re-schedule the debt was disastrous from the point of view of creditworthiness and the chances of further borrowing. By servicing the debt, despite the huge social burden it

¹ Hungary joined GATT in 1973. The accession to the IMF and the World Bank took place in 1982.

required, the Government wanted to impress private foreign creditors and investors.² In other words, the divestment of Hungarian SOEs to foreign investors was an implicit *debt-equity swap*.

Adopting and implementing a privatization strategy that openly favoured foreign investors was not an easy proposition in Hungary either. Like in all other post-communist countries – or indeed in *all* countries of the world – lawmakers and privatization officials had to face suspicion and fear on the part of the electorate. To make matters even worse, the majority of Western “transition-experts” were critical to the emerging case-by-case selling strategy. This approach was called “crazy and disastrous” even three years after its launch, and therefore Hungary was constantly downgraded in comparison to those countries that espoused Czech or Russian-type of voucher privatization.

Fortunately, there were unique circumstances that helped the Government of Hungary. After the introduction of the 1968 economic reforms, Hungary suffered from a chronic underperformance in exports, as the fallout from decades of import substitution strategies. In looking for better export performances, Hungarian policy makers received intellectual support from two of their compatriots: Béla Balassa and Nicholas Kaldor, living in the United States and the United Kingdom, respectively. These outstanding economists were frequent visitors to their native country already in the 1970s.

Both Balassa (1982) and Kaldor (1971) were advocates of *export-led growth*. Their teachings and policy recommendations were well received in Hungary by foreign trade experts such as András Inotai, Béla Kádár, András Köves and András Nagy. From the works of these Hungarian authors, a new theory of industrial development emerged already in the 1980s. From the analysis of export statistics of fast-growing countries, these authors concluded that even moderately sophisticated manufactured goods could not be exported

² Recalls Bertalan Diczházi (1998), a close advisor of Prime Minister József Antall, in a (still) unpublished policy paper (Diczházi, 1998) of that time: “From the perspective of attracting *foreign direct investments*, a policy of in-kind restitution would have especially had serious consequences. After entering office, the Government completed a series of international political and economic negotiations in order to assess the likely reaction of foreign governments, international monetary institutions and leading investor groups to an eventual all-encompassing reprivatization strategy. It became crystal clear that, from a business point of view, the international community would react negatively to changes in the Hungarian economy and society that might jeopardize *retroactively* past investments and newly developed business relationships. And – as far as the future was concerned – such policies would freeze for many years the *majority of potential foreign direct investments*.” (*op. cit.*, p. 26, translated from Hungarian, highlights by Mr. Diczházi.)

successfully unless the country in question was fully integrated into the international networks of TNCs. This change in the perception of understanding the conditions of a successful export-led growth policy turned Hungary by the early 1990s into the only transforming economy conducting a fully-fledged open door policy *vis-à-vis* FDI (Csaba, 1997).

Privatization or M&A

The privatization process in Hungary cannot be understood without stressing strongly its centralized nature. From March 1990 to date, SOEs have been owned, managed and divested by a single institution headquartered in Budapest. This is unique. In most countries, the privatization agency is only a policy arm of a national property fund or the branch ministries and a geographical division of labour characterized the daily work of (both types of) privatization agencies. The first advantage of this extreme centralization was power itself. Privatization went ahead, because the privatization agency had the power to do so. But the benefit of centralization demonstrated itself in the transparency of the procedures as well. For all stakeholders – including foreign and Hungarian investors, the media and the Hungarian public opinion at large – it was much easier to monitor developments in a single organization. This close scrutiny forced discipline upon privatization managers as well.

This was a learning process, in which decision-makers learned from each other, from foreign advisors and from the investors themselves. Surprisingly, in the course of practical work, thorny theoretical questions often presented themselves in a much simpler form. The management of the privatization agency arrived at the following conclusions:

- different investment proposals could be compared adequately only on a cash basis, not against soft promises;
- there was no effective mechanism preventing Hungarian buyers to act as intermediaries for foreign companies or to forbid them to re-sell their newly acquired assets to foreigners at a later stage;
- there was no possibility to distinguish between “true” entrepreneurs on the one hand and “adventurers” on the other;
- divestment of existing SOEs and greenfield FDI went hand in hand as a commercially successful, clean and well-publicized sales transaction helped to attract FDI into other activities through a general improvement of the investment climate;

-
- mass-privatization techniques and sales assisted by soft credits or discounts could lead to a give-away of the country's most valuable firms to politically well-connected persons or even persons linked to illegal activities and corruption.

The top management of the privatization agency became convinced that selling Hungarian companies to foreigners was not only an economically justified strategy (see table 1 on the role of foreign buyers), but it was also a way to protect their own self-esteem. Indirectly, this was also a good strategy in preserving their jobs under the permanent public fire of corruption accusations. Although, it was politically difficult to defend transaction decisions week after week when Hungarian investors were ranked second or third behind foreign investors, a reference to higher (hard currency) cash payments helped enormously.

In the early period, sales agreements were relatively short and simple: x million \$ paid in exchange of y amount of shares of company z . As time passed by, however, new concerns emerged, and it became inevitable to increase the scope and the length of the privatization documents. First and foremost, a section on indemnities and guarantees had to be built in. This was new not only to the privatization officials (mostly economists by training), but also to Hungarian lawyers. New technical terms had to be learned and understood such as closing, default provision, conflict of interest, claw-back, etc. After a few consultations with the legal advisers of the

Table 1. Hungary: Share of foreign currency in total privatization revenues, 1990-1999
(Per cent)

Year	Per cent
1990 ^a	79.1
1991	80.9
1992	61.2
1993	67.3
1994 ^a	7.4
1995	87.2
1996	57.0
1997	61.1
1998 ^a	37.0
1999	71.5

Source: Hungary, State Privatization Agency (SPA).

^a Year of general and local elections.

potential foreign partners, the Hungarian side grasped that *from a Western perspective these privatization deals were mergers and acquisition (M&A) transactions and the language they had to learn was the jargon of the M&A business* (see also the article by Miklos Szanyi in this issue).

In the second half of 1994, Hungarian privatization officials realized that, of the remaining 1,500 Hungarian firms to be privatized, the interest of TNCs was limited to 30-50 manufacturing companies and financial institutions. Only then became it clear that the earlier analytical approach that distinguished between *small-* and *large-scale* privatization was inadequate. From a macroeconomic point of view, special attention had to be devoted to these 30-50 *core* firms (Mihályi, 1996). These were the companies that:

- attracted TNCs;
- could generate significant privatization revenues in hard currency;
- were important as export producers;
- were source of positive externalities on the domestic markets (e.g. banks, telecommunication); and
- needed to be regulated even if privatization had not taken place (e.g. banking, energy and telecommunication).

The recognition of these links helped the privatization agency to concentrate on the very large deals – essentially deals with TNCs – while the divestment of the remaining portfolio was treated almost as a political “public relation” exercise. The importance of this latter point can be hardly overemphasized. It is widely held that rent seeking and asset-stripping intentions are the characteristics of foreign investors. The Central and Eastern European experience, by contrast, suggests otherwise. Short-termism is characteristic to investors with little money (be they foreigners or endogenous). Since in a privatization deal not just money, but scarce top managerial time is involved, together with the prestige of the investor, TNCs can hardly afford such malpractice.

In the process of interpreting post-socialist privatization as an M&A transaction, the latest developments could be sensed in Hungary only recently. By 1999-2000, very few companies remained in the portfolio of the SPA. The Hungarian capital market was starting to produce “real” M&A transactions week after week. TNCs started to buy up Hungarian companies that had been created literally from

scratch 5-10 years before. In certain industries, such as telecommunications, retail trade, financial and advisory services, the target firms had absolutely no connections with the communist past: Hungarian entrepreneurs had created these ventures well after 1989. The very best of these companies were becoming recently targets of takeovers. Logically, the methods of acquiring these firms were the same that we know from the times of privatization. Often, the *dramatis personae* were the same as well, since many former privatization agents had already left the Government and were later on working for TNCs – be they the investors or the advisors of the investor.

The results of privatization

During the period of 1980-1994, the total exports of Hungary stagnated, with blips in 1989 and 1993. It was only in 1995 that exports from Hungary were put firmly on a steeply rising growth path. The connection between export performance and the presence of TNCs was easy to establish. In 1992, half of the top ten Hungarian exporters were still owned and managed by Hungarians. By 1998, of the top ten exporters, only three companies remained under Hungarian management and there was only one, in which the State retained majority ownership (table 2). In this way, the open door policy towards TNCs and the intellectual support for export-led growth policies mutually reinforced each other. Hungary was lucky to find itself in a virtuous circle.

As more and more privatization takes place and the level of FDI grows in more and more economies in transition, the conditions are improving to test the underlying hypothesis of this article through rigorous analysis:

- First, there is a need to test the causality links between the advancement of privatization and economic growth.
- A more challenging task will be to test the hypothesis whether the lessons of the Hungarian privatization can be generalized to other economies in transition. The boxes on the left side of figure 1 presents the stylized facts of the standard privatization policy recommendations. In the standard model, de-etatisation – i.e. the removal of the State from enterprise ownership – is the key step towards increasing competition, increased efficiency and – ultimately – output growth. By contrast, the model on the right hand side of figure 1 directs the focus on

Table 2. Top 20 Hungarian exporters, 1998

Short name of the company	Technique of ownership change	Year established in Hungary	Total investment in Hungary (\$ mn)	Country of majority owner(s)	Industry	Controlled by a TNC?	Main products	Country of top local executive
1 Audi	Greenfield	1993	600	Germany	Automotive	Yes	Components	Germany
2 IBM	Greenfield	1995	150	United States	Electronics	Yes	Components	United States
3 Philips	Greenfield	1989	125	Netherlands	Electronics	Yes	Components	Netherlands
4 Opel	Greenfield	1990	440	United States	Automotive	Yes	End-product	Germany
5 MOL	Privatization through IPO	..	840 ^a	Foreign institutional investors	Oil and gas	No	Intermediary	Hungary
6 GE Lighting	M & A ^a	1988	776	United States	Electronics	Yes	End-product	United States
7 Flextronic	Greenfield	1992	46	United States	Electronics	Yes	Components	United States
8 Dunaferr	Asset management agreement	..	-	Hungary (State)	Iron and Steel	No	Intermediary	Hungary
9 Alcoa	M & A ^a	1993	270	United States	Aluminum	Yes	Intermediary	United States
10 BorsodChem	Privatization through IPO	..	90 ^a	Foreign institutional investors	Chemical	No	Intermediary	Hungary
11 TVK	Privatization through IPO	..	210 ^a	Foreign and Hungarian institutional investors	Petro-chemical	No	Intermediary	Hungary
12 Suzuki	Greenfield	1991	234	Japan	Automotive	Yes	End-product	Japan
13 Ford	Greenfield	1990	180	United States	Automotive	Yes	Components	United States
14 Richter	Privatization through IPO	..	253 ^a	Foreign institutional investors	Pharmaceutical	No	End-products	Hungary
15 Electrolux	M & A	1991	70 ^b	Sweden	Machinery	Yes	End-products	Sweden
16 North-American Bus Industries	Private ownership after liquidation	1993	-	United States	Automotive	No	End-product	Hungary

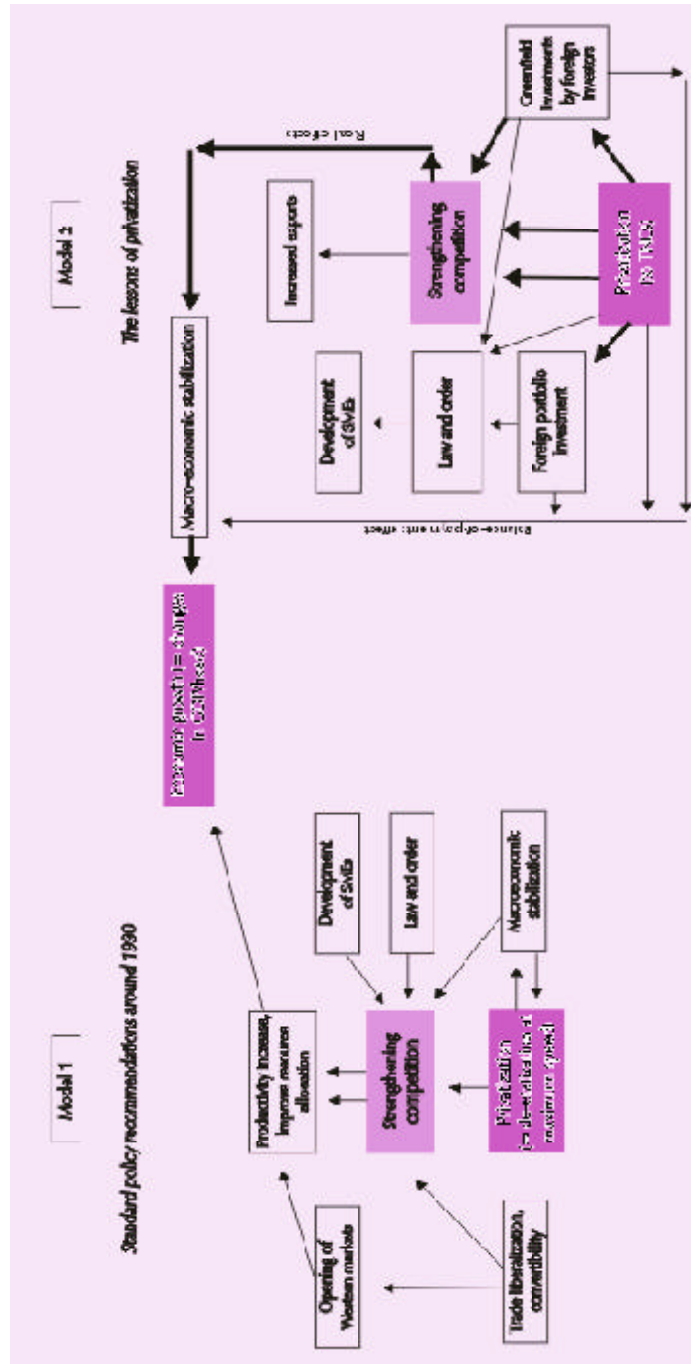
Table 2. Top 20 Hungarian exporters, 1998 (concluded)

Short name of the company	Technique of ownership change	Year established in Hungary	Total investment in Hungary (\$ mn)	Country of majority owner(s)	Industry	Controlled by a TNC?	Main products	Country of top local executive
7 Rába	Privatization through IPO	..	57 ^a	Foreign and Hungarian institutional investors	Automotive	No	Components	Hungary
18 Videoton	Private ownership after liquidation	..	-	Hungary (private individuals)	Electronics	No	Components	Hungary
19 Chinoin – Sanofi	M & A	1990	220	France	Pharmaceutical	Yes	End-product	France
20 Hajdú – Bét	Privatization	1992	...	Hungary (investors)	Food	No	End-product	Hungary

Source: Author's calculations, based on the Book of Lists 2000 (Budapest Business Journal).

- ^a The foreign investor purchased the shares from a Hungarian State-owned commercial bank and not from the privatization agency (debt-equity swap + decentralized privatization).
- ^b The foreign investor purchased the shares directly from a State-owned aluminum holding and not from the privatization agency (decentralized privatization).
- ^c Privatization revenue.
- ^d 1995.

Figure 1. Privatization is not enough – the participation of TNCs is the key of success



FDI and the acquisition of a country's manufacturing capacities by TNCs. The experience of Hungary suggests that only the presence of TNCs can lead to a rise in manufacturing exports, which in turn helps to keep the country on an export-led growth path.

Until 1994-1995, Hungary was the only country in the region that was willing to embark upon the privatization of its strategic companies (the hard core). The first successful mega-deals in the energy and banking industries made headlines in the international business community. Since then, other Central European countries have joined this bandwagon. First Poland, then the Czech Republic, followed the Hungarian path in selling the "crown jewels" of their telecommunications, the petrochemical industry, etc. As a result of these successful sell-offs, these two countries experienced the same that Hungary did: the privatization deals helped the process of attracting greenfield FDI. However, there are at least two countries in Central and Eastern Europe for which these assumptions do not seem to hold. The first "outlayer" is Slovakia, a country next door to Austria, with relatively little FDI. The second counter-example is Slovenia that did almost everything in the opposite way as Hungary did. Nonetheless, the overall economic performance of this country is good enough. Without absorbing large amounts of FDI, Slovenia was capable to double its exports over ten years. It requires further analysis to explain the developments in both countries. I would assume, nonetheless, that within the next 3-5 years, both Slovakia and Slovenia will catch up with the Czech Republic, Hungary and Poland. Then, the correlation between FDI absorption and export performance will be similar in these two countries as well. ■

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Foreign capital in the privatization process of Poland

Stanislaw Uminski*

This article analyses the role of foreign capital in the privatization process in Poland. It seeks to assess the influence of the foreign direct investment involved in the privatization process on enterprise performance. The focus is on qualitative changes that are happening in enterprises privatized with foreign capital, and changes of financial indicators that allow to trace how business performance alters after the entry of a foreign investor.

Introduction

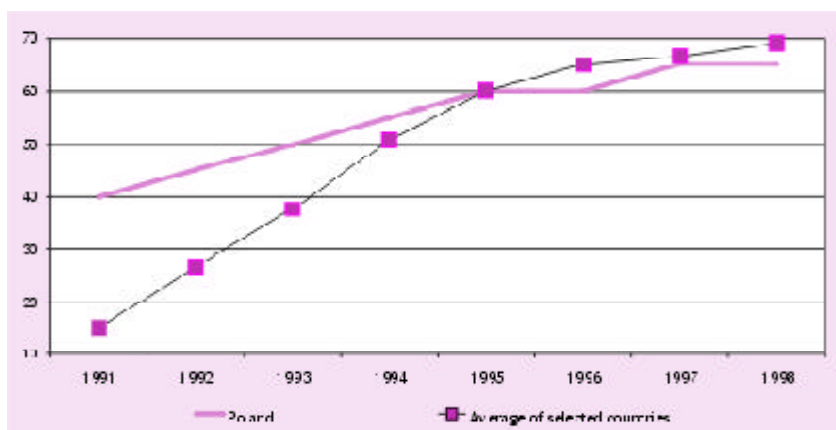
In Poland, the speed of ownership changes (measured by the share of private sector in gross domestic product - GDP) has been slower than on the average in Hungary, the Czech Republic, Estonia, Lithuania, Latvia and Slovenia. These countries are the ones that have attracted most of the FDI coming to the region, or their value of FDI per capita is high. Although in 1991 Poland started with a relatively high share of the private sector in the economy, from 1995 on other countries have outpaced Poland (figure 1). If Poland wants to catch up with those countries again, FDI should play a major role in speeding up the privatization process.

Methods of privatization

The Polish privatization law distinguished two basic methods: indirect privatization (capital path) and direct privatization (liquidation path). The capital path consisted of two stages: during the first, a State-owned enterprise underwent what was called "commercialization", under which it was transformed into a sole-shareholder company, subjected to the rules of the Commercial Code, owned by the State Treasury. In the second stage, the shares of such a company could be sold to either a strategic investor, or on the stock exchange, or both.

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Figure 1. Share of private sector in GDP in Poland and the average of selected Central and Eastern European countries, 1991-1998
(Percentage)



Source: Author's calculations based on EBRD, 1999, and data from the Polish National Bureau of the Census.

In the case of direct privatization, the enterprise chosen underwent liquidation (it was deleted from the registry of State-owned enterprises). Its assets were either sold, or they were contributed in-kind to another company or they were leased out. From an economic point of view, this legal liquidation did not entail a physical liquidation of the assets; it was rather a direct transfer of those assets to new owners, without a concomitant transfer of company shares.

In principle, foreign investors could participate in both forms of privatization.¹ In addition, they could acquire stakes in the so-called portfolio companies, managed by the National Investment Funds (NFI) Programme. The NFI Programme involved 512 companies. NFIs are run by managing firms whose main responsibility is to raise capital and to contribute to the elaboration of development strategies. Until the first half of 1999, the companies belonging to NFIs generated cumulative revenues of 12 billion PLN for the Treasury (9 per cent of all revenues derived from privatization), and registered a gross profitability rate of 2 per cent.²

¹ In direct privatizations, however, foreign investors could participate only if there were no domestic buyers.

² With -3 per cent on average, however, their net profitability rate was still negative.

Where did the foreign capital go?

In reality, as statistics confirm, capital (indirect) privatization created better conditions for foreign participation than the other form. Besides the relative ease of participation, another main reason for such a preference was the fact that most of the large former State-owned firms were privatized through this method. As a result, in 1990-1998, about 45 per cent of the capital in indirect privatization came from foreign investors.³

As for the number of firms, in 1990-1998, capital (indirect) privatization was carried out in 244 sole-shareholder companies owned by the State Treasury; 43 companies were sold through a public offer, while foreign investors gained shares in 214 firms.⁴ In 87 companies, foreign investors became majority owners.⁵ Foreign investors were more interested in manufacturing firms than in services or trade companies. Within manufacturing, most foreign investment went to the food, beverages and tobacco industry, to automobile and automobile parts and tyre production, the wood and paper industry, and the minerals industry.

An important element of the indirect privatization deals – apart from revenues for the State budget – were the commitments that the buyers made to raise the equity capital, to invest, and to transfer licences and technology. In 1990-1998, the value of investment commitments from all investors amounted to \$2 billion. Foreign investors accounted for 75 per cent of that amount.

The revenues from privatizations with foreign and domestic investors (in indirect privatization) are compared in table 1. During 1990-1998, the share of the revenues from foreign investors fluctuated between a low of 47 per cent in 1990 and a high of 98 per cent in 1992. In general, the table confirms that the investment commitments of the foreign buyers were higher than those of the domestic ones.

Direct (liquidation) privatization was mostly applied to smaller enterprises, with no more than 500 employees. As a result, this path

³ Germany alone accounted for 32 per cent of that FDI, followed by the United States (19 per cent), the Netherlands (9 per cent), Sweden (7 per cent), France (7 per cent) and the United Kingdom (5 per cent).

⁴ In 13 cases, shares were sold partly through public offer and to strategic investors.

⁵ In 111 cases Polish, and in 16 cases foreign and Polish investors.

was dominated by employee share ownership programmes. Of the 1,572 completed cases by the end of 1999, 1,119 resulted in leasing out to workers. Moreover, it is difficult to evaluate the exact extent of foreign participation in direct privatization because decisions under this method were often decentralized, without a proper registering at the national level. It is estimated that, till the end of 1997, more than 80 companies were sold to foreign investors through the direct path.⁶

In June 1999, the companies privatized with foreign capital through the indirect method employed 85,000 people. In firms privatized to foreign investors through the direct method, the number of employees of was 21,000.

Table 1. Foreign and domestic investors in indirect privatization, 1990-1998

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1998 ^a
<i>Polish investors</i>										
Revenues from sales of shares (million PLN)	2.4	22.1	5.2	95.4	121.9	341.6	591.0	305.0	5500.0	1043.7
Investment commitments (million PLN)	-	6.2	19.4	326.6	145	354.2	659.2	287.1	45.0	45.0
Number of enterprises	2	9	7	18	18	14	16	25	7	5
<i>Foreign investors</i>										
Revenues from sales of shares (million PLN)	2.1	134.6	290.9	319.4	236.2	1163.1	1139.2	1522.1	1042.4	1042.4
Investment commitments (million PLN)	-	193.8	514.9	894.9	491.0	1240.9	659.0	1715.6	1441.0	1441.0
Number of enterprises	1	8	16	28	14	11	7	12	4	4
Share of foreign revenues to total revenues (per cent)	46.7	85.9	98.2	77.0	66.0	77.3	65.8	83.3	15.9	49.9

Source: "Ownership transformation report 1998", Ministry of the State Treasury 1999.

^a In 1998, the Ministry of the State Treasury classified the revenues from the public offers of Telekomunikacja Polska SA and Bank PKO SA as coming from domestic sources. This is debatable because in fact this was a sale through the stock exchange where many buyers could be foreign. This is why the values for 1998 were adjusted (1998a denotes revenues from privatization with domestic buyers excluding Telekomunikacja and PKO BP). The problem in part stems from the fact that there is no clear-cut division between FDI and portfolio investment. As defined by the OECD benchmark, FDI reflects an element of "lasting interest".

⁶ Foreign investors can only engage in direct privatization, if there are no domestic buyers.

According to the Ministry of State Treasury, until 15 June 1999, strategic investors – including 47 foreign investors as well as domestic ones – acquired 191 of the 512 NFI companies (GUS, 1999). More detailed data for June 1996 to June 1998 indicate that, during that period, foreign investors bought shares in NFIs for \$587 million (69 per cent of all NFI transactions in that period). Foreign investors bought large companies (employing at least 500 people each), and in selected attractive industries (the cement, the automobile and the chemical industries).⁷

In sum, it is difficult to obtain reliable, complete and comparable data on all privatization deals in Poland involving foreign investors. Although the Ministry of the State Treasury and the Main Statistical Office provide some detailed data, those numbers are not compatible or comparable with each other. While this is a problem for exact statistics, the fact that investors could choose among different methods made the whole process more flexible and adjustable to the companies being privatized, depending on their situation.

Effects of privatization with foreign capital on the performance of enterprises

A broad assessment of the impact of privatization with foreign capital in Poland has not yet been carried out so far. Moreover, the relatively high rate of inflation and the prevalence of certain market distortions make such evaluation very difficult. However, there have been some empirical surveys on the performance of privatized companies.⁸

Qualitative effects: surveys of foreign-capital privatization

A review of the literature on the effects of privatization with foreign capital in Poland allows drawing the following conclusions:

- A monitoring of the privatization research during 1990-1997 carried out by the Gdansk Institute on Market Economics in general has found that the performance of enterprises with foreign capital was clearly superior to that of domestically owned firms. In general, foreign involvement resulted in better financial

⁷ In NFIs, France was the leading foreign investor (with 25.2 per cent of the shares acquired), closely followed by Germany (25 per cent), then the United States (7 per cent), Turkey (5.3 per cent), Sweden (4.6 per cent) and the EBRD (3.6 per cent).

⁸ See Szomburg and Dabrowski, 1996; Jarosz, 1999; Baltowski, 1998; Jarosz, 1996; Noga, 1997; Włodarczyk, 1999; and GUS, 1999.

performance (in terms of exports, investment, sales, reduction of long-term and over-due liabilities) and better long-term strategic planning.

- Privatization to foreign investors has strengthened the *market position* of the enterprises concerned, especially in the case of local market-seeking investments.
- The *export performance* of firms privatized to foreign investors is difficult to determine. Some surveys have found less than expected growth in exports, although this expansion has been still faster than in other ownership groups. Others have found that exports actually have decreased in the firms privatized to foreign investors. The results depend on the sampling methods applied in the research. The trade performance of the firms with foreign capital varies largely, depending on the motivations of investors (market versus efficiency seeking FDI). In general, however, it turns out from the data of the Polish Main Statistical Office that enterprises with foreign capital are more active in both exports and imports than their domestically owned counterparts. In 1998, companies with foreign capital generated almost 48 per cent of Poland's exports (and 53 per cent of imports). In the same vein, 62 per cent of Poland's trade deficit in 1998 was generated by enterprises with foreign capital. The Gdansk Institute for Market Economics surveys has analysed in detail the trade performance of firms privatized through different owners during the "early privatization" stage (1990-1994). It has found that, in the firms with foreign capital, the share of exports in sales increased due to a better access to the distribution channels of the parent firms (table 2). In the case of local ownership, in contrast, the share of exports in total sales dropped. The growth of exports was highly correlated with the intensity of product upgrading and replacement (Krajewski, 1996).

Table 2. Average share of exports in total sales, 1990-1994
(Per cent)

Form of ownership in privatized companies	1990	1991	1992	1993	1994	Effect
Dispersed ownership	28.4	26.5	26.0	28.2	29.2	Stabilization
Foreign investor	14.5	14.2	19.6	22.4	22.1	Rise
Domestic investor	45.0	41.2	43.2	35.8	31.5	Drop
Total	26.5	25.0	27.8	27.4	26.9	-

Source: Dabrowski, 1996.

- An important feature of the involvement of foreign capital in the privatization process is a dynamic increase in *investment expenditures*. Janusz Dabrowski (1996) had empirical evidence for 1994 (table 3). Unfortunately, no updated data are available for later years.
- Privatization with foreign capital has often resulted in *commitments* made by investors. These commitments have covered social and work conditions and company development. In 1990-1996, the most common social and workplace-related commitments were: preserving the employment level, workers' training, maintaining the wage level and social benefits (the latter were made under the direct privatization method). As for company development, the most frequent commitments were: modernization of the equipment, transfers of technology and maintenance of product lines (production profile) (Biedrzycka, 1996). It may however be asked to what degree those commitments have been fulfilled. Although some surveys (for instance, by Stefan Krajewski (1996)) have found that commitments were usually fulfilled by the foreign investors, care is required in the interpretation of those results. "Usually" does not provide certainty about a 100 per cent materialization of those results. Therefore a net welfare loss is not excluded if one accepts the hypothesis that foreign investors acquired the privatized assets at a discount price in exchange for their commitments, and later on the host country was in too weak a position to penalize an eventual non-fulfilling investor. Furthermore, when investors accept commitments that would not have been in line with their strategies (e.g. keeping employment at unchanged levels for a negotiated period of time), it often turns out that, after the period expires, those commitments are no longer sustainable (and the investor may reduce employment). The final result of such a scenario is that the strategic adjustments of the enterprise are delayed. In this

Table 3. Average investment expenditures in privatized companies, 1992-1994
(Billion "old" PLZ - before denomination)

Form of ownership in privatized company	1992	1993	1994
Dispersed ownership	33	45	87
Foreign investor	51	198	200
Domestic investor	26	24	46
Total	39	109	127

Source: Dabrowski, 1996.

respect, investment commitments can be judged as the performance requirements that a foreign investor is most likely to follow, while other requirements (relating to employment, technology transfer, balancing foreign trade etc.) seem to be less efficient. It is the host country market, in conjunction with a foreign investor's ownership advantages (for example as defined by John H. Dunning in the OLI⁹ paradigm) that in the end will shape the FDI behaviour in an optimum way.

- Corporate governance and management have substantially improved in firms privatized to foreign investors. Some of the executive staff has changed, and companies have become more "active" in the market.
- Privatized companies divested unproductive assets (like "company" lodgings, kindergartens, summer holiday residences etc.). There is also a tendency towards outsourcing/contracting out some of the services previously undertaken within those companies. This enables firms to concentrate on their core activities while contributing to the development of the services market.
- In firms privatized to foreign investors, various new motivation systems have been introduced, creating opportunities for wage increases and wage-level differentiation. Results of surveys done in Poland indicate that, after privatization, wages in foreign affiliates increased faster than in firms privatized to domestic owners.
- Capital privatization has won employees' support, which may be explained by investment in human capital. Although the qualification requirements are higher, too, foreign investors often undertake training leading to higher work efficiency and responsibility at work.
- Although general opinions on the performance of enterprises after privatization with foreign investors' engagement are positive, some differences can be seen in the perception of workers, medium-level managers and top-level managers (table 4).

Dabrowski provides a synthetic evaluation of the post-privatization performance of firms, by ownership form, in 1990-1996 (table 5). In general, foreign investors have been found to exert the strongest positive influence on enterprises.

⁹ O - ownership, L - location, I - internalization. See more in Dunning (1993) on this eclectic paradigm of FDI.

Table 4. “Positive change” of a firm’s position due to entry through privatization of foreign investors, 1990-1996
(Percentage of positive perception of changes)

Item	Firm’s position in town	Firm’s position in Poland	Firm’s position in the world
Workers (N* = 294)	14.1	35.0	41.4
Medium-level managers (N = 188)	8.9	40.0	59.4
Top-level managers (N = 93)	18.9	46.7	68.5

Source: Danecka and Lojko, 1996.
N* - number of persons surveyed.

Detailed financial performance

Since 1991, the Polish Main Statistical Office (GUS) has collected and published data on privatized firms. They enable us to compare, for example, the performance of companies privatized through different methods of privatization. It is also possible to trace the performance of companies privatized to foreign investors in a historical perspective.

Table 6 indicates that, from 1997 onwards, the “cost-level index” was the lowest in the companies privatized to foreign investors through the indirect (“capital”) method. The cost level used to be much higher in the sole-shareholder companies owned by the State Treasury and in State-owned enterprises.

Table 5. Post-privatization performance of firms by ownership form, 1990-1996

Type of investor	Financial situation	New products	Investment	New markets	Promotion	Employment
Dispersed	+	0	+	0	++	+
Foreign	++	++	+++	++	+++	++
Domestic	0	0	++	0	+	+

Source: Dabrowski, 1996.

Legend:

+++ positive influence, very high.

++ positive influence, high.

+ positive influence, moderate.

0 no influence.

- negative influence.

Trends are somewhat different in the gross profitability rate¹⁰ (table 7). It is to a certain degree surprising that the profitability of enterprises privatized to foreign investors is not that high as it should, in principle, reveal the relative efficiency of the various forms of ownership changes. This may in part reflect an intra-firm transfer of profits through transfer pricing (table 7).

Table 6. Cost-level index^a in enterprises privatized through different methods, 1992-1999

Item	1992	1993	1994	1995	1996	1997	1998	1 st half of 1999
Enterprises privatized with foreign capital by "capital path"	93.0	94.0	94.2	93.4	95.6	93.6	95.0	94.1
Enterprises leased to employees	93.3	93.3	93.7	93.7	94.0	94.6	95.5	96.0
Sole-shareholder companies of the State Treasury	94.8	95.2	94.6	95.1	99.0	97.3	101.4	102.4
State-owned enterprises	-	95.9	96.1	97.1	98.4	97.5	99.5	105.6

Source: Polish Main Statistical Office (GUS).

^a The cost level index is calculated as total costs incurred during the economic activity to total revenues from economic activity.

Table 7. Gross profitability rate^a in firms privatized with different methods

Item	1992	1993	1994	1995	1996	1997	1998	1 st half of 1999
Enterprises privatized by "capital path" with foreign capital	5.1	4.9	5.2	6.5	4.4	6.3	5.1	5.8
Enterprises leased to employees	7.2	7.4	6.8	6.3	6.0	5.5	4.5	4.0
Sole-shareholder companies of the State Treasury	2.7	2.8	6.1	5.4	2.3	3.0	-0.8	-2.3
State-owned enterprises	-	2.9	3.6	3.4	2.4	3.4	0.5	-5.6

Source: Polish Main Statistical Office (GUS).

^a Calculated as a ratio of profit (loss) earned to the revenue from economic activity.

¹⁰ As measured by share of exports and investment in total sales.

Conclusions on the performance of domestic companies versus foreign affiliates in Polish manufacturing

The influence of foreign capital on enterprise performance can also be traced by comparing various indices, e.g. propensity to export, propensity to invest or total factor productivity across different forms of ownership. This is not strictly limited to privatization; it can nevertheless be treated as an index showing how the presence of foreign capital influences the business sector in general. What is important in this respect is the fact that foreign capital contributes to ownership changes and increases the share of the private sector. Therefore it can be said that FDI leads to the “privatization” of the Polish economy in the broadest sense.

Table 8 compares the performance of domestically and foreign-owned enterprises. In all respects, the latter perform better. What is really important is their relatively good performance in exports and investment expenditures. Poland faces the problem of a trade deficit (that reached -7.6 per cent of GDP in 1999). The exports of foreign affiliates open a window of opportunity for improvements in

Table 8. Comparison of domestically and foreign-owned companies in Poland, 1993-1998

Item	1993	1994	1995	1996	1997	1998
<i>Share of exports in total sales (per cent)</i>						
Domestic enterprises	19.7	13.9	15.5	16.7	15.5	16.2
Foreign affiliates	21.8	27.6	24.3	25.8	26.9	29.3
<i>Value of exports per employee (in fixed prices, 1993) thousand PLN</i>						
Domestic enterprises	9.0	5.6	7.5	8.0	9.6	10.1
Foreign affiliates	6.6	10.5	17.5	23.3	29.2	35.7
<i>Share of energy costs in total sales (in per cent)</i>						
Domestic enterprises	3.6	3.6	3.2	3.3	2.5	2.7
Foreign affiliates	1.4	1.4	1.1	1.0	1.2	1.2
<i>Share of investment outlays in total sales (in per cent)</i>						
Domestic enterprises	5.1	4.5	5.6	6.1	6.4	7.9
Foreign affiliates	11.9	10.7	9.7	8.8	9.8	12.0
<i>Investment outlays per employee (in fixed prices, 1993) in thousand PLN</i>						
Domestic enterprises	2.3	1.8	2.7	2.9	4.0	4.9
Foreign affiliates	3.6	4.1	7.0	7.9	10.7	14.7

Source: Author's calculations, based on Polish Main Statistical Office (GUS) data.

this respect. Also, their propensity to invest (measured by the share of investment expenditures in sales) is relatively high. Poland “inherited” used-up capital stock in manufacturing from the planned economy that needs modernization and investment. In this respect, FDI contributes to investment processes that otherwise could not be effective enough with the use of domestic (scarce) sources of capital.

FDI and foreign trade

In foreign trade, a relatively high and growing share of technology-intensive, difficult-to-imitate products characterizes FDI-related exports. Their share in total joint-venture¹¹ exports increased from 13 per cent in 1994 up to 22 per cent in 1997. At the same time, the share of this category of goods in domestic companies’ exports was stable at 10 per cent. As a result of joint-venture presence and activity, the share of technology intensive difficult-to-imitate commodities in Poland’s exports increased from 10 to 15 per cent. We also observed a decreasing share of labour-intensive goods in joint-ventures exports, from 45 per cent to 31 per cent, while the share of this category of goods in domestic enterprises’ exports increased. In general, the joint ventures’ share in Poland’s total exports of technology-intensive difficult-to-imitate goods has increased from 31 to 62 per cent.

Joint ventures also generate more than 56 per cent of the technology-intensive imports. This shows that these enterprises undertake economic activity that is relatively more technologically intensive (than that of domestic enterprises) and that they are able to absorb technologically intensive imports.¹² Data indicate that Poland has revealed comparative advantages in both labour-, resource- and capital-intensive goods. In tilting the balance, the activity of joint ventures contributes to a change in Polish exports and its revealed comparative advantages towards of higher-technology goods.

Case studies

In order to assess the industry-specific and local influence of foreign capital on enterprise performance, two case studies were prepared. The first analyses the automotive industry. The second one assesses privatization at the local level in the Kujawsko-Pomorskie voivodship.

¹¹ “Joint venture” as used in the text may refer to any enterprise with foreign capital.

¹² For detailed results see Uminski and Stepniak, 1999.

The Polish automotive industry: a case study

The Polish automotive industry has been at the forefront of attracting FDI to Poland. Although there have been some greenfield projects (e.g. General Motors/Opel), the majority of foreign capital entered through privatization (Fiat Auto Poland, Daewoo, Scania, Volkswagen). Based on statistical data obtained from the Polish Main Statistical Office broken down by ownership, the share of foreign affiliates in sales was rather low in 1993 (5 per cent). By 1998, it had increased to 34 per cent. The share of foreign affiliates in the industry's employment was 16 per cent in 1998. In 1993, labour productivity was higher in the State-owned sector, but it declined in the following years. By 1998, labour productivity not only increased in the foreign-owned sector but also outpaced other forms of ownership. Major differences can be seen in total factor productivity (TFP), too. The average TFP in 1993-1998 in the public sector was -0.2, while in the private sector it reached 1.38, and in the foreign-owned sector 2.32 (table 9).

In 1990, 266,000 passenger cars were produced in Poland; in 1998 their number was 592,000. Employment in the industry increased slightly, from 97,000 in 1993 to 107,000 people in 1998.

Table 9. Selected performance indicators of the automotive industry in Poland, 1993-1998

Item	1993	1994	1995	1996	1997	1998
<i>Share of foreign capital in sales (per cent) in car industry</i>	4.7	9.6	22.3	27.7	30.8	33.8
<i>Share of foreign capital in employment (per cent) in car industry</i>	2.4	3.3	4.2	7.3	10.0	16.4
<i>Labour productivity in car industry ^a</i>						
Public ownership	66.3	86.9	37.1	37.4	32.4	34.0
Private ownership	7.3	8.3	31.2	103.4	101.1	24.9
Foreign ownership	20.3	15.7	222.6	401.1	367.0	95.1
<i>Share of exports in sales in car industry</i>	-	8.6	11.7	25.4	21.2	36.3
<i>Share of investment outlays in sales in car industry</i>	-	2.5	4.0	4.8	9.6	15.0

Source: Author's calculations based on Polish Main Statistical Office data.

^a Output per employee, thousand PLN in fixed prices 1993.

The ratio of exports to sales and of investment to sales in 1993-1998 increased in the whole automotive industry in Poland. Positive spillovers in the whole industry occurred as far as cooperation with domestic subcontractors are concerned. In 1999, almost 70 per cent of the parts used in car production or assembly in Poland came from Polish producers. Reports on the Polish car market indicate that the scope of subcontracting in companies privatized with foreign capital in Poland is much higher than for greenfield projects. Thus, one can assess the technology transfer through privatization as higher than through greenfield FDI.

Fiat Auto Poland is one of the largest investors in the automotive industry. Fiat has been present in the Polish car market since 1921. In 1987, the decision was taken to produce a small city car in Poland – the Cinquecento. Production started in 1991. However, in 1989 the process of economic reforms and transformation caused a sharp decline in car sales (together with the opening of the market for imported second-hand cars). In this situation, the Fiat Cinquecento project was put in question. Fiat decided to participate in the privatization process of FSM (a company producing the Cinquecento and other vehicles). Fiat management took the decision that the costs of abandoning the Cinquecento project in Poland would be too high and that FDI in FSM was the only way to react. In 1992 Fiat engaged in the privatization of FSM, and Fiat Auto Poland was established.¹³

Fiat Auto Poland was incorporated into Fiat's international strategy. New models were introduced into the Polish plant. Investment in Poland was utilized to minimize cost of production and to increase market share. Exports and imports of cars and components between Fiat and Fiat Auto Poland have increased. Subcontracting in Poland rose; for example, in 1992, 55 per cent of the components (in terms of value) were supplied by Polish sources and in 1997 their share increased to more than 75 per cent. But the number of contractors was reduced, resulting in a concentration in the whole system of subcontracting. Moreover, subcontractors were offered technical training and stimulated to improve quality through implementing the quality standards ISO 9001 and ISO 9002. Fiat also induced foreign car-component producers to invest in Poland. Some of them entered

¹³ The Fiat Auto Poland case study is based on: Dallago, 1998, and also on data by SAMAR.

the Polish market through privatization, the others through greenfield FDI. Employment was reduced from 24,000 people in 1991 to 12,000 in 1996. But this resulted also from the process of outsourcing social services and selling car components producing divisions of FSM to Fiat's affiliates Texid and Magnetti Marelli. The real, "per saldo", influence on employment was rather insignificant. Fiat Auto Poland registered a sharp increase in sales from 135,000 cars sold in 1991 to more than 340,000 in 1999, of which 174,000 were exported. In 1999, Fiat was the only manufacturer in the automobile industry that had registered a significant trade surplus, contributing to an improvement in Poland's foreign trade position. Fiat Auto Poland witnessed an important increase of productivity from 7 cars per employee in 1991 to more than 30 in 1998. After the entry of Fiat into FSM, almost all chief executive officers were Italians; but this strategy of management proved to be inefficient and Fiat quickly replaced them with Polish staff.

Foreign capital in the privatization in Kujawsko-Pomorskie voivodship

Some effects of foreign ownership on business performance can be assessed at the local level. For this purpose, the Kujawsko-Pomorskie voivodship had been chosen, where the participation of foreign capital in the privatization of the wood and paper industry (Framondi), furniture industry (Klose) and electronics/telecommunication equipment industry (Lucent Technologies) has been important. A comparison of various indices demonstrates that the foreign-owned sector in this voivodship performs much better than the domestic private and domestic public-owned firms. The differences are most salient in sales per employee, exports per employee, investment per employee, share of exports in sales and capital productivity. The list of the voivodship's main export products contains various goods produced by the industry with foreign capital: paper products, furniture and electronics. Almost 55 per cent of the voivodship's exports originate from firms with foreign capital. A notable effect of privatization on innovatory activity was the setting-up of a research Bell Laboratory by Lucent Technologies in Bydgoszcz. The Laboratory employs 220 researchers; 48 countries use the results of the Laboratory.

Conclusions

In comparison with other countries of Central and Eastern Europe, the dynamics of ownership changes in Poland – as measured by the share of the private sector in GDP – have been sluggish. This suggests a potential role for FDI in speeding-up ownership changes. Poland is slower than other countries because many important industries (such as telecommunications and public utilities) are still too strictly regulated, due to lobbying. Some delays in negotiations with potential investors were also due to unclear and/or complicated ownership relations. Calculations based on Ministry of Ownership statistics and balance-of-payments figures show that, between 1994 and 1998, 6 to 10 per cent of total FDI coming to Poland was directed to the privatization process. In comparison with other countries of the region, Poland shows a rather poor correlation between FDI and privatization. In fact, studies on failure of FDI in privatization in Poland confirm this statement (Kopec, 1997; Kulawczuk, 1997). Administrative obstacles and lengthy negotiations make privatization with foreign involvement difficult. Also other countries – especially Hungary – seem to be more effective in promoting their economic strengths as a place for FDI which can be an example and lesson for Poland, especially if we compare FDI level per capita, which in Poland is relatively low.

In 1999, however, it seemed that the trend was reversed. In 1999 foreign investors spent around \$3 billion on stocks and shares in State-owned enterprises. To compare, revenues from privatization from Polish investors amounted to \$120 million. This shows that foreign investors account for the largest part of revenues generated

Table 10. Comparison of selected economic indices in different forms of ownership in the Kujawsko-Pomorskie voivodship, 1998

Item	Form of ownership		
	Public	Private	Foreign
Sales per employee (thousand PLN)	105.3	155.2	204.9
Exports per employee (thousand PLN)	9.1	15.2	48.8
Investments per employee (thousand PLN)	7.9	10.6	13.2
Share of exports in sales (per cent)	8.6	9.8	23.8
Share of investments in sales (per cent)	7.5	6.8	6.5
Capital productivity (sales per unit of capital stock in PLN)	1.5	2.3	4.9

Source: Author's calculations based on Polish Main Statistical Office data.

from privatization. While discussing revenues from privatisation, one should realize that the inflow of FDI contributes to the appreciation of the zloty, causing export competitiveness to drop. This is why part of the privatization revenues are transferred and kept at a separate dollar account held with the Polish National Bank (NBP), so that this would lessen appreciation pressures. In consequence, what is promoted by FDI inflows is not a price-based kind of competitiveness, but rather competitiveness in terms of quality that is positively stimulated by those inflows.

The dispersion of the Polish privatization process (among direct privatization, indirect privatization and national investment funds) makes economic evaluations and research difficult because no statistical data from these three main methods are available in a comparable manner. In comparison with other countries, data available on Polish privatization with foreign involvement are therefore less coherent and comparable.

Although foreign involvement in the Polish economy is relatively low compared to, for instance, the Czech Republic and especially Hungary, some economists and policy makers are of the opinion that possibilities for foreign capital to invest should be restricted, or at least preferences should be given to domestic capital. This conclusion seems to be rather wrong because Poland can not build a market economy without capital; and, unfortunately sufficient capital resources cannot be provided from domestic sources. Statistics reveal that foreign involvement (as measured by the share in revenues in sales) is relatively high in manufacturing of radio and television equipment, personal hygiene products, washing powders and cosmetics, the paper industry, electrical equipment, the ceramic and cement industry, car manufacturing and banking. But one also should realize that it seems rather impossible to find domestic investors who would be able to participate actively in ownership changes in these industries.

As far as policy recommendations to enhance the interest of foreign investors in the privatization process are concerned, Poland should better promote investment possibilities and make the whole privatization process more clear and less bureaucratic and lengthy. Also, the regulatory environment (tax law, rules applicable to special economic zones, company law) should be more stable and clear to reduce the impact of politics and administrative decisions on

enterprises. Making regulations clearer and less discretionary would also curb corruption. This is very important because Poland's position in the Transparency International corruption rankings is far from satisfactory. One should remember that this index has an influence in the business world, and it certainly does not contribute positively to Poland's ranking as a country to invest in. It is very important to proceed with market liberalization and open up industries so far restricted to FDI. This would not only lead to more common elements of FDI and privatisation, but also help to improve the competitiveness of the economy. ■

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RESEARCH NOTES

Modes of FDI entry and firm performance: the Czech case

Alena Zemplinerová and Martin Jarolím*

This research note analyzes the role and the impact of foreign affiliates in the Czech Republic, distinguishing between greenfield investment and mergers and acquisitions. It focuses on manufacturing enterprises. The core of the study is a statistical regression analysis, illustrating trends in foreign direct investment and their impact on the host economy. The data indicate for each enterprise its ownership (foreign, domestic) and how it was established in order to identify the firms with foreign capital and to determine their greenfield or mergers and acquisitions status. The main variables used for our analysis are ownership of the enterprise, means of establishment, employment, sales (output), own capital, fixed capital, assets, salaries, value added and investment, all those data recorded by the Czech Statistical Office from the balance sheets and financial statements of enterprises. In addition, the 1998 data also report direct imports by each firm. The research note focuses on the impact of foreign direct investment on market competition as measured by market concentration. Furthermore, it investigates the role of foreign direct investment in technology transfer to Czech manufacturing industries.

Introduction

The development of foreign direct investment (FDI) flows to the Czech economy has been rather unequal during transition. It was initially determined by large foreign acquisitions through privatization. The large-scale privatization programme, which started in 1991, affected property valued in excess of \$35 billion (based on book

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value),¹ of which almost 40 per cent was privatized through vouchers, i.e. exclusively to domestic investors. About 30 per cent of the property was either sold to domestic investors via direct sales or tenders or transferred to municipalities. Some tenders were open only to domestic investors. Foreign investors accounted for a mere 10 per cent of the \$35 billion on sale.²

Given this discrimination against foreign investors during privatization, greenfield investment has often been the only option to enter the Czech market. But there could have probably been many more greenfield projects in the Czech Republic if there had not existed an enormous bureaucracy to “navigate” an enterprise trying to establish a new plant.

This research note analyzes the role and impact of foreign affiliates in the Czech Republic, distinguishing between greenfield investment and mergers and acquisitions (M&A), while focusing on manufacturing enterprises.³ The core of the study is a statistical regression analysis, illustrating trends in FDI and their impact on the host economy. Focus is on the role of FDI as a channel of technology transfer and a test for spillover effect. Furthermore we investigate the impact of FDI and foreign trade on market structure.

The analysis is based on a unique and new set of micro data on Czech manufacturing enterprises for 1994 and for 1998 obtained from the Czech Statistical Office (CSO). The sample consisted of 2,003 manufacturing enterprises in 1994 and 2,046 manufacturing enterprises in 1998, with 100 or more employees each. For every enterprise, ownership (foreign, domestic) and the mode of establishment (greenfield versus M&A) was indicated.

The main variables used for our analysis are employment, sales (output), own capital, fixed capital, assets, salaries, value added, investment and direct exports, all those data recorded by CSO from

¹ Out of about 5,000 enterprises undergoing large-scale privatization, only 144 were privatized partially or fully to foreign investors. Projects with foreign participation were subject to particular scrutiny as they often affected the best enterprises in the economy. The process of privatizing a company through the National Property Fund was unavoidably bureaucratic.

² The VW-Skoda deal is not included in this value as it was concluded before the large-scale privatization programme had started in 1991.

³ With a 36 per cent share in total output and a 29 per cent share in the total number of workers, manufacturing is an important sector of the Czech economy.

the balance sheets and financial statements of enterprises. In addition, the 1998 data recorded direct imports for each firm.

For the sake of analysis, we aggregated the firms' data according to their main activity.⁴ We identified 23 manufacturing industries according to 2-digit NACE and 101 manufacturing industries according to 3-digit NACE. The 3-digit level of NACE allows for linking data from industrial statistics with trade statistics. Thus, we were able to include imports in the total supply when computing concentration ratios.

Impact of FDI on the host economy

As of 1994, the share of foreign affiliates in Czech manufacturing was still relatively low. With about a 12 per cent share in output, foreign penetration was still far behind the ratios of small developed countries, in which this share is about half of total output. By 1998, the share of foreign affiliates in Czech manufacturing increased to about a third. The number of greenfield projects grew faster than that of M&As between 1994-1998. This can be explained by the diminishing role played by privatization, offering fewer opportunities for acquisitions.

The potential of FDI in the Czech privatization process has been underutilized. The method of selling directly to strategic foreign investors has not been fully exploited. Instead, a "Czech way" of privatization has been pursued. This voucher method led to a very dispersed ownership structure without establishing a long-term commitment among owners in privatized companies. It did not become a source of necessary capital investment, which was also true for the direct sales of State-owned companies to domestic owners. As a result, a great differentiation in the performance of individual companies has taken place.

During the period of 1994-1998, the Government of the Czech Republic had certain reservations about *foreign investors* (usually for political reasons), and thus maintained certain administrative barriers to foreign penetration into domestic markets. The disincentives for foreign investors took not only the form of being excluded from privatization but also restrictions on their ownership

⁴ An enterprise can manufacture products falling into several industries (groups of products); its classification is determined by the nature of the major part of its output.

of land and/or ownership of real estate, a special approval process, and restrictions on certain industries or in public procurement.

Table 1 demonstrates that there are not only big differences in foreign penetration across industries but also the relative importance of the two main modes of entry varies. While M&As dominate industries such as tobacco, motor vehicles, man-made fibres, cement, rubber and plastics, greenfield projects are frequent in television, radio, personal computer and electrical equipment production. On the other hand there are industries in which foreign penetration is zero or negligible. Domestic enterprises own 100 per cent of coke and petroleum production. Low penetration can be found not only in traditional industries such as textiles, footwear or machinery but also in basic metals and chemicals. It can be concluded that, while M&As are more prevalent in industries requiring firm-level restructuring, greenfield investments dominate cases of industry-level restructuring.

Table 1. Share of foreign M&A and greenfield enterprises in Czech manufacturing output, 1994 and 1998
(Per cent)

NACE	Industry	Output 1994		Output 1998	
		M&A	GF	M&A	GF
15	Food manufacturing	0.09	0.03	0.14	0.07
16	Tobacco manufacturing	n.a.	n.a.	0.95	-
17	Textile manufacturing	0.02	0.05	0.10	0.12
18	Apparel manufacturing	0.03	0.04	0.12	0.05
19	Leather and allied product	0.02	-	0.03	0.04
20	Wood product manufacturing	0.06	-	0.13	0.20
21	Article manufacturing	0.05	0.04	0.22	0.09
22	Printing and related support	0.18	0.05	0.14	0.21
23	Petroleum and coke products	-	-	-	-
24	Chemical manufacturing	0.05	0.00	0.14	0.02
25	Plastics and rubber products	0.26	0.02	0.37	0.09
26	Non-metallic mineral product	0.20	-	0.38	0.05
27	Primary metal manufacturing	0.02	-	0.04	0.02
28	Fabricated metal product	0.10	0.01	0.12	0.08
29	Machinery manufacturing	0.04	0.01	0.08	0.07
30	Office machines	0.06	-	0.08	0.25
31	Electrical equipment	0.07	0.07	0.15	0.31
32	TV, radio	0.04	-	0.20	0.33
33	Medical instruments	0.08	0.02	0.07	0.14
34	Automotive	0.56	0.01	0.71	0.11
35	Other transportation equipment	0.02	-	-	0.02
36	Other manufacturing	0.03	0.02	0.07	0.31
37	Recycling	0.01	-	0.34	0.00
Total	Total manufacturing	0.10	0.02	0.22	0.09

Source: Authors' calculations, based on CSO data.

Foreign affiliates tend to be more than twice as big on average in terms of total sales than domestic firms (table 2). The higher levels of labour productivity and export shares observed in foreign affiliates might be interpreted as a result of their size. To control for the size effect, we computed the weighted means (shown in parentheses) with the weights derived for average sales per firm, allowing us to compare domestic and foreign firms of similar sizes.

As a next step, we compared the performance of greenfield enterprises and M&As. This comparison (table 3) reveals significant differences between the performance of these two groups in the short term. Greenfield firms are significantly smaller on average than foreign acquisitions and have a higher investment rate.

Table 2. Comparison of productivity, outward orientation and wages between domestic and foreign-owned enterprises in manufacturing in 1998^a

Industry	Output as percent worker	Export per of sales	Wages Average worker	Average sales per firm
Food manufacturing	1.9 (0.6)	4.3 (1.4)	1.4 (0.5)	3.1
Textile manufacturing	1.3 (1.2)	1.3 (1.2)	1.2 (1.1)	1.1
Apparel manufacturing	1.0 (1.2)	2.4 (2.9)	1.1 (1.3)	0.8
Leather and allied product	1.4 (2.5)	1.8 (3.1)	1.1 (1.9)	0.6
Wood product manufacturing	2.2 (1.1)	1.9 (0.9)	1.5 (0.7)	2.0
Article manufacturing	1.1 (0.9)	1.0 (0.7)	1.0 (0.8)	1.3
Printing and related support	1.5 (0.6)	0.9 (0.4)	1.3 (0.5)	2.5
Chemical manufacturing	1.8 (2.4)	1.3 (1.8)	1.2 (1.6)	0.7
Plastics and rubber products	2.2 (1.0)	1.8 (0.8)	1.3 (0.6)	2.3
Non-metallic mineral product	2.4 (1.0)	1.0 (0.4)	1.4 (0.6)	2.4
Primary metal manufacturing	1.3 (3.0)	3.2 (7.1)	1.0 (2.1)	0.5
Fabricated metal product	1.5 (1.1)	2.6 (2.0)	1.1 (0.9)	1.3
Machinery manufacturing	1.5 (1.2)	1.1 (0.9)	1.2 (1.0)	1.2
Office machines	0.9 (0.6)	2.8 (1.9)	0.8 (0.5)	1.5
Electrical equipment	1.4 (0.6)	1.9 (0.8)	1.1 (0.5)	2.2
Medical instruments	1.3 (1.1)	2.9 (2.5)	1.1 (0.9)	1.2
Transportation equipment	2.8 (0.2)	1.7 (0.1)	1.4 (0.1)	11.6
Other manufacturing	1.5 (0.5)	0.9 (0.3)	1.2 (0.4)	3.2
Total manufacturing	1.8 (0.9)	1.9 (0.9)	1.2 (0.6)	2.1

Source: Authors' calculations, based on CSO data.

^a Values obtained using weights in brackets ().

Table 3. Comparison of performance between GF and M&A enterprises in total manufacturing in 1998

Item	Greenfield/M&A
Labour productivity (Y/L)	0.7
Outward orientation (X/S)	1.0
Wages per worker (W/L)	0.9
Average sales per firm (S/N)	0.5
Average employment (L/N)	0.7
Inward orientation (M/S)	1.3
Investment goods per sales (I/S)	1.3
Capital per labour (K/L)	0.6

Source: Authors' calculations, based on CSO data.

Market structure and foreign direct investment

In economies in transition, the negative effects of FDI on competition are potentially more probable than in other countries as domestic firms often have weak management and are technologically backward. In addition, protection mechanisms such as anti-trust policies are not as sophisticated as in developed countries.

An example of undesirable investor activity is the effort to acquire a monopoly position via market protection. As many markets in the centrally planned economies used to be heavily monopolized, there was a potential danger of maintaining or strengthening such monopoly positions by new private owners. For an investor it is more attractive to buy a monopoly – a major market share – than to buy an enterprise in a very competitive environment.

In the 1990s, Czech manufacturing experienced a rapid and deep change in market structures. Most manufacturing markets de-concentrated between 1989 and 1995. Relatively extensive restructuring on the industry level as well as on the firm level occurred. This restructuring however did not lead to any massive investment activity; it was mainly splitting the large companies into several economically independent units and shifting the production programmes within the existing technology. During the last few years, a renewed tendency towards concentration through domestic mergers can be observed again in selected markets (Zemplerová, 1998).

Table 4. Manufacturing industries, by share of largest producer (not adjusted for imports: CR1, and adjusted for imports: CR1 (M)) and share of mergers and acquisitions in sales (M&A/S), 1998

NACE	Industry	CR1	CR1(M)	M&A/S
355	Other transport equipment n.e.c.	100.0	78.9	-
351	Ships and boats	100.0	35.7	-
247	Man-made fibres	100.0	42.6	100.0
323	Television and radio receivers	92.8	35.7	0.0
160	Tobacco products	90.9	67.4	90.9
341	Motor vehicles	88.6	51.7	88.6
176	Knitted or crocheted fabrics	85.0	22.7	-
152	Processed and preserved fish	84.3	71.0	-
183	Furs; articles of fur	82.8	14.1	-
245	Glycerol; soap and detergents, cleaning	73.6	37.6	-
364	Sports goods	72.0	24.6	-
283	Steam generators (except central heating)	70.6	64.3	-
293	Agricultural and forestry machinery	55.9	31.6	-
273	Other iron and steel	51.6	32.4	-
251	Rubber products	51.1	27.2	51.1
315	Lighting equipment and electric lamps	47.5	27.8	3.5
311	Electric motors, generators and transformers	46.7	19.5	0.5
244	Pharmaceuticals, medicinal chemicals and	46.4	27.3	26.5
362	Jewellery and related articles	43.9	21.2	-
154	Animal and vegetable oils and fats	41.8	34.4	-
361	Furniture	41.6	18.1	2.1
263	Ceramic tiles and flags	40.7	28.8	28.2
314	Accumulators, primary cells and primary	40.0	12.4	50.5
322	Television and radio transmitters, apparatus	39.5	30.6	39.5
297	Domestic appliances n.e.c.	39.3	21.0	-
272	Tubes	39.3	17.0	2.1
264	Bricks, tiles and construction products,	37.7	29.1	20.8
363	Musical instruments	37.1	18.8	-
300	PC	37.0	1.2	11.7
205	Other products of wood; articles of cork	36.3	13.9	36.3
265	Cement, lime and plaster	36.1	30.1	94.3

Source: Authors' calculations, based on CSO data.

We computed the shares of the largest producers with and without adjustment for imports according to the 3-digit NACE classification as indicators of the concentration of markets. We then related that to the share of M&A projects in the market output, as there is a greater changes of a monopoly position with M&As than with greenfield investments. We did not find a significant correlation between M&As and the share of the largest producer at the 3-digit level, especially if we considered imports as an additional competitive force.

As follows from table 4, market structure and market concentration depend on the type of the product and imports in that market. The national levels of concentration in domestic supply are often very high. For many markets, imports correct the concentration levels sufficiently. In a small economy such as the Czech Republic, this is a very important consideration as in many markets competition can be maintained only via imports.

Hence in some markets, foreign trade matters a lot, while in others, very little or not at all. Many goods have markets with national or local boundaries. Depending on the character of the product, foreign investors are either aiming at acquiring a local market share or at increasing their share on world markets. In the first case, exports are minimal. In the latter case, the foreign investor exports the majority of the output. In the first case it has to compete with domestic producers; in the latter with other transnational corporations on world markets. In the first case, foreign involvement in a market often results in monopoly with negative consequences for the host country. In the second case, it is more probable that foreign investors will expand production, increase capacities and invest in new technologies, thus improving both quality and marketing.

Monopolistic and oligopolistic structures exist in many markets, especially in small economies. Cross-border M&As can increase the market power of existing monopolies or oligopolies as they, unlike greenfield foreign investments, do not widen market capacities. In concentrated local markets such as cement, with FDI liberalization, anti-monopoly policies should be implemented and strengthened as there is a higher probability of abuse of a monopoly position. However with the liberalization of trade, the definition of the relevant market is changing.

FDI and productivity growth

A major problem faced by the Czech economy at the beginning of the reforms in the 1990s was a low level of knowledge of new technology, since strict limitations had been imposed on access to foreign technology prior to the transition process. Lifting barriers to foreign capital, along with expanding trade linkages with the developed economies, were and are expected to create the potential for rapid increases in productivity and efficiency and, consequently, for the growth of the Czech economy. The objective of this section is

to investigate the role of FDI as a channel of technology transfer to Czech manufacturing industries between 1994 and 1998.

To examine whether foreign presence affects the rate of productivity growth, we followed Haddad's and Harrison's methodology and assumed a production function, with value-added Y as a function of two inputs, capital and labour:

$$Y_{ijt} = A_{ijt} f(L_{ijt}, K_{ijt}).$$

The level of productivity is given by A_{ijt} , which is assumed to vary across firms within each industry j and across time t . If we differentiate this, take logs, and use the fact that the value of the marginal product for each factor equals its cost, we have:

$$d \log Y_{ijt} = dA_{ijt} / A_{ijt} + a_l d \log L_{ijt} + a_k d \log K_{ijt}, \quad (1)$$

where dA/A is productivity growth, and the coefficients on the growth of labour and capital are their share in value added.

We test the hypothesis that productivity growth is affected by the share of foreign investment both at the firm level and at the industry level. For that purpose, we distinguish between foreign affiliates and firms that did not establish partnerships with foreign firms, and ask whether total factor productivity growth rates of these sets of firms differ. Moreover, we distinguish between the foreign affiliates and analyze separately the impacts of greenfield investments and M&As on the productivity growth by introducing dummy variables *GREEN* and *MA*. To test for the so-called spillover effect, i.e. for the extent to which the presence of FDI in a given industry increases the rate of productivity growth of indigenous firms in this industry, we included a variable *FDI*. *FDI* measures the share of foreign fixed assets in each industry's total fixed assets. To control for the other factors affecting productivity growth, we included an industry dummy *C* and an industry concentration index *CR* measuring the share of the four largest firms in the total sales of each industry. Thus, given the assumptions, productivity can be decomposed into the following components:

$$dA_{ijt} / A_{ijt} = aGREEN_{ijt} + bMA_{ijt} + cFDI_{jt} + dCR_{jt} + eC_j. \quad (2)$$

Combining (1) and (2) yields

$$d \log Y_{ijt} = a \text{GREEN}_{ijt} + b \text{MA}_{ijt} + c \text{FDI}_{jt} + d \text{CR}_{jt} + e C_j + a_l d \log L_{ijt} + a_k d \log K_{ijt}. \quad (3)$$

The reported book value of fixed assets may be inaccurate due to a re-valuation of the fixed capital at the beginning of the transition process. The book value of capital is more an accounting value, which does not correspond to (and is higher than) the “real” value of the capital stock. Therefore, it is necessary to distinguish between capital inherited from the pre-transition period and new capital based on investments during the 1990s. Depreciation of the capital stock seems to be an appropriate measure capturing this difference as different rates of depreciation have been imposed on new and “old” capital. Thus, we employ depreciation as a measure of capital in our model.

Estimation results for equation (3) given in table 5, column 1, represent the results we obtained excluding an industry dummy. At the firm level, the coefficients on *GREEN* and *MA* are positive and statistically significant (*GREEN* at a 10 per cent and *MA* at a 1 per cent significance level), indicating that firms with both types of foreign investment achieved higher growth rates of productivity. The coefficient on *MA* is slightly larger than that on *GREEN*, indicating that M&As achieved higher productivity growth than the greenfield enterprises during the analyzed period; but they do not differ significantly. As for the spillover effect, the coefficient on *FDI* is positive and statistically significant (at 5 per cent level), which confirms the hypothesis that foreign presence positively affects productivity growth for indigenous firms. The result remains unchanged when we exclude all foreign affiliates from the sample and test for the spillovers from industry-level foreign investment on wholly domestically-owned firms. A certain drop in magnitude for the coefficient on *FDI* is nevertheless observed. The coefficient remains positive, but becomes statistically insignificant (see column (3)), not sufficient to prove the presence of technology spillovers from FDI. The concentration index has a negative effect on productivity growth, which would support the hypothesis that competitive pressure in less concentrated industries forces firms to become more productive, but the coefficient is significant (at a 10 per cent level) only when a regression is run without foreign affiliates included in the sample.

To implement the assumption that productivity growth varies across industries, we included industry dummies (see columns (2)

and (4)). The direct impact of FDI on productivity growth of foreign affiliates represented by the coefficients on *GREEN* and *MA* dummy variables is not significantly affected by the inclusion of industry effects. We observe only a slight drop in the coefficient on *MA* and a slight increase in the coefficient on *GREEN*, but M&A enterprises still achieve higher productivity growths than the greenfield projects. The coefficient on *FDI* remains positive, but becomes markedly smaller and statistically insignificant. A drop in magnitude is observed also for the coefficient on *CR*, which remains statistically insignificant.

Policy implications

Our analysis has shown that enterprises with foreign participation assist economic re-structuring and speed up the process of transforming entire industries. The results can have some policy relevance. The negative consequences of the “Czech way” in early privatization have been addressed by the Government of the Czech

**Table 5. Testing for the impact on productivity growth
(dependent variable: Change in *log Y*)^a**

	All firms		Non-FDI firms	
	(1)	(2)	(3)	(4)
d(log L)	0.974 (17.458)	0.974 (17.963)	0.995 (15.658)	0.994 (16.136)
d(log K)	0.094 (3.826)	0.096 (4.077)	0.098 (3.379)	0.101 (3.536)
GREEN	0.143 (1.774)	0.152 (1.852)	-	-
MA	0.186 (3.472)	0.179 (3.384)	-	-
FDI (sector)	0.183 (2.370)	0.056 (0.573)	0.124 (1.404)	0.075 (0.646)
CR	-0.117 (-1.587)	-0.074 (-0.925)	-0.137 (-1.762)	-0.081 (-0.960)
Industry dummies	No	Yes	No	Yes
R-square	0.50	0.53	0.47	0.50
N	1,291	1,291	1,086	1,086

Source: Authors' calculations, based on CSO data.

^a t-statistics in parentheses.

^b FDI(sector) = share of foreign fixed assets in each three-digit sector.

^c CR = concentration index CR4 for each three-digit sector not adjusted for foreign trade.

Republic through a revitalization programme for large manufacturing enterprises. In the first phase of this programme, the government took over the companies and invested in their restructuring. In the second phase, re-privatization to strategic foreign investors should take place.

Furthermore, the Government is putting more emphasis on establishing a favourable investment climate. Following a prolonged debate and in light of the trade-balance situation, in April 1998, the Government approved a national investment incentive package, which was amended and codified in May 2000. The incentives include corporate tax relief for up to 10 years, financial support for creating new jobs, grants for retraining new employees and a provision for low-cost building land or infrastructure. Incentives apply equally to both foreign and domestic investors and are provided in the case of M&As as well as greenfield investments. However there are some limitations: for instance, investment must be made in the manufacturing sector, and at least 50 per cent of the production line must consist of machinery listed on a Government-approved list of high-technology machinery. The original requirement to invest at least \$10 million within three years has been reduced to \$5 million in regions with a high unemployment rate. As of mid-2001, 63 firms had been awarded incentives, and 50 more applications were being processed. Each of these grants however have to be approved by the anti-trust authority as it represents a kind of subsidy and establishes unequal conditions for different firms.

In the long-term, with the entry of foreign investors, the potential for economies of scale is better utilized. In many markets efficiency dictates an increasing market concentration in order to meet the competitive scales of production, advertising and R&D. Thus, the competitive process itself can form barriers to entry. It can end in a dominant firm's monopolistic or oligopolistic position, and an increase in the market power of such a firm. That again can reduce the competitive pressure to increase efficiency over time. Collusion and cartels become more probable.

In order to curb the negative consequences of a firm's dominant position in a market, and prevent collusion, countries adopt anti-monopoly laws. Anti-trust policies rely heavily on the concept of concentration levels and changes in concentration. When approving mergers, the pro-competitive and anti-competitive consequences of the increase in market share are being weighed.

Currently, anti-trust policy cannot be carried out by national institutions alone as the relevant market cannot be limited to a domestic market, but instead must be adjusted for foreign trade. Cross-border M&A requires joint action by both countries in which a company operates. Competition regulators need to cooperate in order to analyze and evaluate the respective consequences of M&As. International mergers call for international policies. ■

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Annex table 1. Share of foreign M&A and greenfield enterprises in employment, 1994-1998
(Per cent)

NACE	Industry	Employment 1994		Employment 1998	
		M&A	GF	M&A	GF
15	Food manufacturing	0.09	0.02	0.12	0.05
16	Tobacco manufacturing			0.95	0.00
17	Textile manufacturing	0.02	0.02	0.08	0.06
18	Apparel manufacturing	0.03	0.03	0.09	0.06
19	Leather and allied product	0.02	0.01	0.05	0.03
20	Wood product manufacturing	0.04	0.00	0.10	0.08
21	Article manufacturing	0.04	0.03	0.19	0.09
22	Printing and related support	0.11	0.03	0.10	0.15
23	Petroleum and coke products	0.00	0.00	0.01	0.00
24	Chemical manufacturing	0.03	0.00	0.13	0.02
25	Plastics and rubber products	0.21	0.02	0.22	0.07
26	Non-metallic mineral product	0.10	0.00	0.20	0.05
27	Primary metal manufacturing	0.01	0.00	0.03	0.01
28	Fabricated metal product	0.06	0.01	0.09	0.06
29	Machinery manufacturing	0.03	0.01	0.05	0.03
30	Office machines	0.04	0.00	0.08	0.41
31	Electrical equipment	0.07	0.05	0.13	0.26
32	TV, radio	0.03	0.00	0.08	0.29
33	Medical instruments	0.07	0.02	0.05	0.11
34	Automotive	0.30	0.01	0.44	0.11
35	Other transportation equipment	0.02	0.00	0.00	0.01
36	Other manufacturing	0.02	0.01	0.07	0.09
37	Recycling	0.03	0.00	0.23	0.00
Total	Total manufacturing	0.06	0.01	0.12	0.07

Source: Authors' calculations, based on CSO data.

Annex table 2. Share of foreign M&A and greenfield enterprises in exports 1994-1998 and imports 1998
(Per cent)

NACE	Industry	Exports 1994		Exports 1998		Imports 1998	
		M&A	GF	M&A	GF	M&A	GF
15	Food manufacturing	0.15	0.06	0.29	0.16	0.30	0.20
16	Tobacco manufacturing	n.a.	n.a.	1.00	0.00	0.98	0.00
17	Textile manufacturing	0.02	0.06	0.14	0.14	0.16	0.21
18	Apparel manufacturing	0.02	0.04	0.27	0.08	0.17	0.06
19	Leather and allied product	0.02	0.01	0.05	0.08	0.02	0.05
20	Wood product manufacturing	0.11	0.00	0.16	0.33	0.15	0.46
21	Article manufacturing	0.07	0.02	0.22	0.09	0.21	0.25
22	Printing and related support	0.11	0.02	0.19	0.13	0.22	0.20
23	Petroleum and coke products	0.00	0.00	0.00	0.00	0.00	0.00
24	Chemical manufacturing	0.06	0.01	0.16	0.04	0.22	0.04
25	Plastics and rubber products	0.50	0.03	0.51	0.10	0.51	0.14
26	Non-metallic mineral product	0.26	0.00	0.38	0.06	0.47	0.09
27	Primary metal manufacturing	0.03	0.00	0.10	0.07	0.08	0.10
28	Fabricated metal product	0.11	0.01	0.23	0.18	0.28	0.17
29	Machinery manufacturing	0.04	0.01	0.07	0.09	0.11	0.20
30	Office machines	0.07	0.00	0.18	0.40	0.31	0.10
31	Electrical equipment	0.17	0.09	0.14	0.46	0.15	0.54
32	TV, radio	0.05	0.01	0.19	0.55	0.17	0.60
33	Medical instruments	0.20	0.03	0.13	0.31	0.14	0.19
34	Automotive	0.72	0.02	0.76	0.12	0.73	0.14
35	Other transportation equipment	0.03	0.00	0.01	0.04	0.01	0.01
36	Other manufacturing	0.03	0.04	0.06	0.30	0.08	0.58
37	Recycling	0.06	0.00	0.43	0.00	0.25	0.00
Total	Total manufacturing	0.15	0.02	0.33	0.14	0.35	0.18

Source: Authors' calculations, based on CSO data.

Annex table 3. Share of foreign M&A and greenfield enterprises in investment 1994-1998
(Per cent)

NACE	Industry	Investment 1994		Investment 1998	
		M&A	GF	M&A	GF
15	Food manufacturing	0.15	0.10	0.21	0.13
16	Tobacco manufacturing	n.a.	n.a.	0.97	0.00
17	Textile manufacturing	0.02	0.05	0.05	0.20
18	Apparel manufacturing	0.02	0.05	0.17	0.08
19	Leather and allied product	0.01	0.00	0.08	0.17
20	Wood product manufacturing	0.03	0.00	0.15	0.46
21	Article manufacturing	0.01	0.03	0.22	0.24
22	Printing and related support	0.36	0.04	0.10	0.18
23	Petroleum and coke products	0.00	0.00	0.00	0.00
24	Chemical manufacturing	0.16	0.00	0.14	0.03
25	Plastics and rubber products	0.33	0.12	0.49	0.13
26	Non-metallic mineral product	0.32	0.00	0.42	0.10
27	Primary metal manufacturing	0.02	0.08	0.06	0.03
28	Fabricated metal product	0.16	0.02	0.13	0.19
29	Machinery manufacturing	0.06	0.01	0.09	0.12
30	Office machines	0.03	0.00	0.17	0.74
31	Electrical equipment	0.25	0.11	0.19	0.42
32	TV, radio	0.07	0.01	0.22	0.62
33	Medical instruments	0.13	0.09	0.04	0.35
34	Automotive	0.73	0.00	0.70	0.12
35	Other transportation equipment	0.02	0.00	0.00	0.01
36	Other manufacturing	0.05	0.07	0.07	0.15
37	Recycling	0.04	0.00	0.19	0.00
Total	Total manufacturing	0.22	0.04	0.27	0.14

Source: Authors' calculations, based on CSO data.

FDI in economies in transition: M&As versus greenfield investment

Marina Wes and Hans Peter Lankes*

This note uses survey data to analyze how the characteristics, determinants and impacts of foreign direct investment projects in economies in transition differ for mergers and acquisitions and greenfield investments. It provides some elements of judgement to address the question whether host countries should have a preference for either mode of entry. It suggests that host countries can derive benefits from both types of investment, albeit of a somewhat different nature.

Introduction

Foreign direct investment (FDI) can cement and promote the transition process in Central and Eastern Europe (CEE) and the Commonwealth of Independent States (CIS), and it can play an important role in helping to realize the region's growth potential. The capital stock in economies in transition is large by the standards of middle-income countries, but inefficiently employed and partly obsolete. FDI can contribute directly by supplying finance and raising employment. At the same time, investment for restructuring, combined with improved management and western technology offers opportunities for raising the yield of some of the existing capital. Apart from its role in capital accumulation, FDI can also make a significant contribution to the transition process through upstream and downstream linkages and demonstration effects. This can be one of the most effective channels for transferring technologies, management and labour skills, and marketing channels, and it helps to foster a market-based business culture.

It is important to recognize the heterogeneity of FDI. Different projects have quite different characteristics, are undertaken for different reasons, and are attracted by different aspects of host

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economies. This note uses survey data to analyze how the characteristics, determinants and impacts of FDI projects into economies in transition differ for (i) cross-border mergers and acquisitions (M&As) and (ii) greenfield investment. This note draws on a particular set of survey results. It does not attempt to analyze these results in the context of the literature; nevertheless, the richness of the survey enables the presentation of some interesting results, which may be useful as a basis for further research.

This note is organized along those dimensions in which greenfield FDI and M&As are most different. The next section provides some basic information on the survey and the sample. This is followed by a section on the analysis of some characteristics of the projects in the sample. The subsequent section looks at the differing control modes of investments in greenfield projects and M&As, followed by a section analysing the differences in investor motivation between greenfield investors and M&As. The before the last section looks at the spillovers of the investments, and other impacts on the host country, followed by a concluding section.

The survey and the sample

The selection of companies took place in two stages. First, a pre-survey questionnaire was sent to several thousand companies in early 1995, investigating both their involvement in CEE/CIS economies and their willingness to participate in a lengthy interview. 1,405 companies responded, 628 giving a contact name and address for an interview. Interviews were conducted with 117 of the companies that identified a potential interviewee. Twenty eight of the interviewees answered questions on two distinct projects, giving a maximum response per element of the questionnaire of 145 (table 1). Of the firms nominating an individual to be interviewed the selection of those actually interviewed was reached on the basis of several criteria.

First, their location: interviews were conducted only in Western Europe. Second, their sector of operation: the research looks at investments by companies primarily engaged in manufacturing activities. It excludes services sector and infrastructure firms, and firms whose main function is primary resource extraction. Third, the continuing willingness of firms to participate in a lengthy interview.

In 134 cases respondents indicated whether or not the investment was of a greenfield or of an acquisition nature. The 134

projects cover 16 economies in transition (table 1), and employ 39,000 workers. The total value of the projects is euro 6.6 billion.

It is important to note that the survey excludes an important share of the FDI population. Manufacturing remains the single largest host sector for FDI, accounting for 40-60 per cent of the FDI stock in most economies in transition. Nevertheless, FDI into the services sector is becoming increasingly important as a result of liberalization and privatization in telecommunications and electricity distribution. In some of the more advanced transition countries, there have also been substantial foreign investment into the financial industry. In the Russian Federation and a few other CIS countries with vast natural resources, the primary sector accounts for the largest share of inward FDI.

Hans P. Lankes and Anthony J. Venables (1996) have illustrated, using the same data, the importance of distinguishing between projects whose primary function is distribution and those associated with production (either to supply local or export markets). They showed that projects whose primary function is distribution or local supply regard market access as the central motivating factor for their investment and report benefits from proximity to customers. In contrast

Table 1. Number of investment projects covered in the survey, by host country

Country	Number of investment projects
Central and Eastern Europe	
Bulgaria	4
Croatia	2
Czech Republic	22
Estonia	4
Hungary	19
Latvia	4
Poland	27
Romania	5
Russian Federation	26
Slovakia	5
Slovenia	3
Ukraine	9
Visegrad countries, n.s.	1
Central Asia	
Kazakhstan	1
Kyrgyzstan	1
Turkmenistan	1

Source: EBRD.

export-oriented projects cite production cost considerations as their prime motivating factor. These projects are more footloose, more likely to replace or displace production elsewhere in the world, more closely integrated in the activities of the parent firm, and somewhat more upstream in the production chain. For much of this note, we divide greenfield projects into production and distribution projects; and it emerges that the characteristics of the different types of projects differ significantly.¹

Table 2 shows that projects whose primary function is distribution are relatively more likely to be of a greenfield nature. For 16 per cent of the sample (21 projects) the primary role was to be a sales base to promote exports from plants in the rest of the world to CEE and the CIS. Of these distribution projects, 81 per cent were of a greenfield nature, suggesting that greenfield investments are four times more likely to be sales/servicing bases than M&As. Production for the supply of local or regional markets was the main purpose of 68 projects (52 per cent of the sample). The remaining 42 projects (32 per cent of the sample) have their primary function as a production base to supply markets outside the region (Western Europe and other world markets). Serving as a production – rather than distribution – base is the primary role of 94 per cent of all M&A projects in the sample.

Basic characteristics of projects

Half the foreign investment projects in the survey are greenfield investment, while the rest involved the acquisition of an existing company (table 3). It seems safe to assume that the latter were most commonly in the form of a privatization.

Table 2. Primary role of the project

Role	Acquisition	Greenfield	Share of greenfield (%)
Distribution	4	17	81
Local supply	38	30	44
Export supply	22	20	48

Source: EBRD.

¹ Because there are only four acquisition investments whose primary role is distribution, we chose not to disaggregate this category.

As shown in table 3, the average total capital value of production-oriented greenfield investment is three times larger than that of acquisitions, while the capital value of distribution greenfield investments is very small. On the other hand, employment levels in acquisition investments are significantly higher than in greenfield investments, 559 versus 171 (40) employees respectively. Greenfield investments in the sample are therefore significantly more capital intensive than acquisition investments. In greenfield investments the foreign partner would also typically own a larger share of total capital committed. In interpreting these results, it is important to remember that the survey focuses on manufacturing (73 per cent of the sample) and that it does not include large infrastructure and utility privatization deals.

The relative importance of M&As and FDI as a mode of entry is roughly the same for all country groups in the sample (table 4). Across the region, half the investments are in the form of M&As and the other half greenfield investment.

This finding is in contrast to some of the results found elsewhere in the literature, typically arguing that greenfield investments are generally more prevalent in countries of advanced transition than in countries of early transition. Willem H. Buiters, Ricardo Lago and Hélène Rey (1998) argue that this is so because the cost of a greenfield investment can be assumed constant irrespective of the country where it takes place, whereas the returns of the investment in early transition countries are more volatile and may be less favourable because of inferior macroeconomic prospects. If a country has an unfavourable macroeconomic environment, it will pay for it through high discounts on the prices of its existing immobile assets. Therefore, the less

Table 3. Basic information about the projects

Information	Greenfield		
	Acquisition	Production	Distribution
Total number of projects	67	50	17
Average total capital value of project (in millions of euros)	32.41	101.55	2.1
Capital commitment by foreign parent (share of total equity capital)	63.59	70.05	81.80
Turnover (in millions of euros)	43.64	37.77	16.18
Employment	559.26	171.24	39.59

Source: EBRD.

advanced the country on the transition path, the stronger the incentive to invest in existing rather than new assets, *ceteris paribus*

One possible reconciliation of this may relate to one-off opportunities created by the transition process. As reported in a later section, gaining a first-mover advantage over competitors through low-cost acquisitions in privatization programmes has been a moderately important consideration driving investments in the form of M&As.

Modes of control of projects

The projects in the sample operate under different modes of control. Table 5 shows that 11 projects (8 per cent of the sample) operate by means of licensing or subcontracting agreements, 73 (52 per cent of the sample) as joint ventures, and 55 (40 per cent of the sample) as fully foreign-owned investments. As shown in table 5, greenfield investments are twice more likely to be under full foreign ownership than M&As. On the other hand, M&As are much more likely to be joint ventures (67 per cent of M&As are joint ventures versus 39 per cent of greenfield investments).

As discussed in Lankes and Venables (1996), the control mode is systematically associated with a number of other project characteristics. First, there is an association between control mode and function. Full ownership is most likely for distribution projects, followed by export supply projects, and least likely for local supply projects. 69 per cent of all projects which are fully foreign-owned investments are of a greenfield nature. Conversely, the most common form of control in greenfield investments is full foreign ownership,

Table 4. Location of the projects

Location	Greenfield			Share of distribution in greenfield (%)
	Acquisition	Production	Distribution	
CIS	19	13	6	32
Hungary and Czech Republic	20	16	5	24
Poland and the Baltic States	19	14	2	13
Southeast Europe and other	9	7	4	36
Total	67	50	17	34

Source: EBRD.

with 53 per cent of all greenfield investments in the sample controlled in this manner. On the other hand, the most common form of control in M&As in the sample is in the form of joint ventures with local firms; 67 per cent of all M&As in the sample are joint ventures. Licensing and subcontracting are relatively uncommon modes of control, both for greenfield investments and for M&As.

Table 5. Modes of control

Location	Acquisition	Greenfield		Share of acquisition in total (%)
		Production	Distribution	
Licensing to local firm	3	1	-	0.75
Subcontracting with local firm	2	4	1	0.33
Joint venture with local firm	45	22	6	0.67
Full foreign ownership	17	27	11	0.38

Source: EBRD.

One of the characteristics of joint ventures is that they create a dependence of the sponsor on the existing owner and partner in the venture. For this reason, many companies prefer greenfield investments and the full foreign ownership that tends to be associated with them. Although, the sample selection does not permit a full analysis of the determinants of successful versus unsuccessful projects, Table 6 shows a cross-tabulation of project status by entry mode (greenfield versus M&A).² It yields a fairly clear picture. M&As are more than twice as likely to be postponed or abandoned as greenfield investments. This highlights the risks related to complications with the privatization procedures and possible tensions with the management of the existing firms.

Table 6. Status of the projects

Location	Acquisition	Greenfield		Share of acquisition in total (%)
		Production	Distribution	
Planning stages	17	16	1	50
In operation	39	30	15	46
Postponed/abandoned	11	4	1	69

Source: EBRD.

² There are few unsuccessful projects in the sample, and few managers answered the full set of questions on unsuccessful projects.

Determinants: investor motivations

What explains developments in FDI in economies in transition? The analysis of FDI suffers not only from problems of measurement, but also from weaknesses in the theoretical foundation. The principal industrial organization theories of FDI focus on the internalization of transaction costs and on the behaviour of oligopolies. Other theories emphasize locational factors (market size, factor cost advantages, proximity to major markets, and the legislative, political, and economic environment) but suffer from the diversity of motives that firms have in establishing production bases abroad. In a classification according to John H. Dunning (1993), firms may seek resources (e.g. raw materials, labour and technology), markets, efficiency (in optimizing the production network of transnational corporations (TNCs)) or strategic assets (such as brand names or existing distribution systems). The weight of the individual locational factors differs depending on these motives.

Some evidence can be derived from other surveys among potential investors in CEE and the CIS. As shown in an overview of surveys in the 1994 EBRD *Transition Report* (EBRD, 1994), market access is a dominant factor in investor decisions. In this earlier part of the transition, the “first-mover advantage” was an important motivating factor for firms. Factors cost advantages were generally rated as less important. Legislative uncertainty and regulatory hassle are stated as the most commonly cited investment obstacles. More recent surveys confirm these results (see for instance an overview by Miklós Szanyi, 2000), although they also suggest that factor cost advantages are becoming an increasingly important motivation of foreign investors as the role of the “first-mover advantage” is declining. This is linked to a greater integration of enterprises in CEE into the TNC corporate networks and of CEE economies into the EU single market. None of these surveys distinguish between greenfield investments and M&As.

How do investor motivations differ between greenfield FDI and M&As? Survey respondents were asked to score the factors that motivated them to consider the investment, with each factor ranked on a scale of 1 (unimportant) to 6 (important). Table 7 reports responses to the question: When the project was originally planned, what was the importance of each of the following considerations in your motivation for considering the project? The answers are classified by entry mode.

The numbers in the table are the average scores by firms in each category, and an asterisk denotes statistical significance relative to M&As – at the 5 per cent level. Three types of considerations feature in table 7 – market access considerations, cost considerations, and the response to opportunities created by the transition. We discuss each of them.

Market access

Many studies have found access to local markets to be the major motivating factor in FDI decisions (see for instance, EBRD, 1994). Its importance is also illustrated in the table above, with access to local markets being the single most important consideration for both greenfield investors and M&As. Access to other regional markets in CEE and the CIS is the second most important factor for M&As and the third most important factor for greenfield investors. Access to EU and European Economic Area (EEA) markets is typically not a major factor for either type of investor.

Costs

The second set of considerations mentioned in table 6 are supply side issues of production cost. Most striking is the importance attached to production costs by greenfield investors. While production costs are only of moderate importance in the case of mergers and acquisitions, they are of much greater importance for supply-oriented greenfield investment.

Table 7. Importance of investor motivations
(6 = most important, 1 = least important)

Motivation	Acquisition	Greenfield Production	Distribution
Production costs relative to other locations	3.45	4.17*	2.83
Availability of skilled labour	2.73	3.04	3.58*
Access to local markets	4.86	4.55	5.47
Access to other CEE/CIS markets	3.81	3.40	3.69
Access to EU/EEA markets	2.24	2.04	1.82
Response to one-off opportunities created by the transition	3.48	2.36*	4.00

* denotes statistical significance at the 5 per cent level relative to acquisition investments.

Source: EBRD.

The importance of comparative advantage considerations in the case of greenfield investors is also reflected in their actual cost structure. Table 8 shows that the share of skilled labour costs in total production costs is much higher for greenfield investment than for M&As, whereas the share of unskilled labour is more than twice as high for M&As as for greenfield investors. Skilled labour is a particularly important component of overall production costs in greenfield investments that serve distribution purposes. Intermediate products are of roughly equal relative importance for M&As and for production-oriented greenfield investments, but of much lesser importance for distribution-oriented greenfield investments.³

Firms were also asked to give estimates of the wage and labour productivity differentials, between their FDI project and a similar plant in their primary country of operation. Table 9 shows that wage rates for greenfield investments and M&As are roughly the same. However, in the case of skilled labour, productivity is significantly higher for greenfield investments than for M&As, while the relative wage differences are similar. The rows reporting wage rate/productivity give the difference in wage rates divided by the difference in productivity, i.e. a measure of the labour cost saving on the project relative to an alternative in the primary country of operation. The effective cost of unskilled labour to greenfield investors is 25 per cent of that in their primary country of operation, while that for M&As is 35 per cent. In the case of skilled labour, the effective cost to greenfield investors is 31 per cent of that in their primary country of operation, while that for M&As is 43 per cent.

Table 8. Distribution of production costs
(Per cent)

Costs	Greenfield		
	Acquisition	Production	Distribution
Unskilled labour	13.0	4.5	6.4
Skilled labour	13.8	19.6	49.3
Intermediate products	52.7	57.0	14
Capital costs	20.6	19.2	34.3

Source: EBRD.

Note: all numbers are a percentage of total production costs.

³ This is consistent with the previous point. Greenfield investments appear to have both high capital and labour costs than M&As; labour costs are higher for greenfield investments at least in part because a more skilled labour force is employed.

Opportunities created by the transition

The third type of motivating factors listed in table 8 is response to one-off opportunity created by the transition. This category was included in order to capture the possibility that FDI projects were responses to privatization programmes and other one-off opportunities created by the exceptional circumstances of the transition. As could be expected, this factor was a more important motivating factor for M&As than for greenfield investments. This difference is statistically significant at the 5 per cent level. Of the one-off opportunities, the most important is to gain a first mover advantage over competitors. However, in the case of M&As only, the opportunity for low-cost acquisition in privatization programmes was also a moderately important consideration.

Table 9 also decomposes the importance of market access and cost considerations between distribution and production centres. It shows that for (greenfield) distributors, market access considerations are relatively more important – with production costs playing virtually no role. For those greenfield investments aimed at supply of regional and global markets, both market access and cost considerations are important in the investment decision.

Table 9. Costs and productivity as a percentage of home-country costs

Cost items	Greenfield		
	Acquisition	Production	Distribution
For unskilled labour			
Difference in wage rates	15	11	11
Difference in productivity	43	43	47
Wage rate/productivity	0.35	0.26	0.23
For skilled labour			
Difference in wage rates	25	24	26
Difference in productivity	57	78	88
wage rate/productivity	0.43	0.31	0.30

Source: EBRD.

The impact on the host economy: spillovers, linkages and expansion plans

FDI can play an important role in the transition process. Apart from its role in capital accumulation, it tends to have a “package” of attributes that can make a significant contribution to the transition through upstream and downstream linkages and demonstration effects. It can for instance enforce modern standards of product quality and supply reliability upon local producers through its procurement management. This can in turn provide both learning externalities from which other purchasers can benefit and promote market-oriented behaviour. Advanced marketing methods can have an impact on distribution systems and market logistics as well as on competition.

The most important reason why countries try to attract FDI is perhaps the prospect of upgrading technology. Since technology – especially organizational and other managerial technology – is to some extent a public good, host countries can benefit even if activities are carried out in wholly owned foreign affiliates. These benefits take the form of various types of externalities or productivity spillovers. For instance, local firms may be able to improve their productivity as a result of forward or backward linkages with foreign affiliates, they may imitate technologies, or hire workers trained by foreign companies. Foreign firms also often have market access advantages, including competitive advantages in entering world markets, established international distribution networks, and lobbying power (Blomström and Kokko, 1998).

Some of the productivity and market access spillovers operate via the linkages between foreign affiliates and their local suppliers and customers. The spillover occurs when local firms benefit from the foreign affiliate’s superior knowledge of product or process technologies or markets, without incurring a cost that exhausts the gain from the improvement. Backward linkages arise from the relationship of the affiliates of TNCs with suppliers, while forward linkages stem from contacts with customers. Local content in the production of foreign affiliates is clearly one of the main determinants of the strength of linkages (Matouschek and Venables, 1998a and 1998b).

Table 10 shows that greenfield investment tends to be more integrated within the firm than M&As, both with respect to the source of inputs and the destination of outputs. This difference is particularly pronounced in the case of inputs. In the case of greenfield investment, twice as many inputs are sourced from within the corporation than in the case of M&As (55 per cent versus 26 per cent respectively). 17 per cent of the output of greenfield investors goes for further processing within the corporation, versus 11 per cent in the case of M&As.

Survey evidence in many developed and developing countries has shown that there is a tendency for the share of local inputs to increase over time (Blomström and Kokko, 1998). There is some evidence in this survey to confirm this. Both greenfield investors and M&As expect the sourcing of inputs from within the corporation to decrease over the next five years, with more greenfield investors anticipating a decrease.

M&A also get a greater proportion of inputs from within the region through existing supplier networks. In the case of acquisitions, 10 per cent of the intermediate inputs from within the corporation is from plants within CEE and the CIS. In the case of greenfield investment, this percentage is less than one per cent. More than half (55 per cent) of all inputs from outside the corporation are sourced from CEE and the CIS in the case of M&As – versus less than 44 per cent for greenfield investors. These results are even more pronounced on the sales side.

Table 10. Project orientation

Orientation	Greenfield		
	Acquisition	Production	Distribution
% inputs within corporation	25.1	51.9	68.6
Change in 5 years*	-0.13	-0.38	-0.43
% inputs outside corporation	74.9	48.1	31.4
Change in 5 years*	0.13	0.39	0.43
% sales within corporation	10.53	18.53	12.50
Change in 5 years*	0.00	0.00	0.00
% sales outside corporation	89.47	81.47	87.50
Change in 5 years*	-0.03	0.00	0.00

Source: EBRD.

* 1 for increase, 0 for no change, and -1 for decrease.

Relocation of production and expansion plans

For manufacturing projects, 70 per cent of projects surveyed stated that the investment involved an expansion of the firm's overall production capacity. As illustrated in table 11, FDI in the form of an M&A is twice more likely to be a new production line or brand (for the firm) than in the case of greenfield investment. 12 per cent of all M&As in the survey involve the introduction of a new production line or brand, versus 5 per cent in the case of greenfield FDI. On the other hand, in the case of greenfield investment, the project is twice more likely to be a relocation of an existing production line, with 29 per cent of all greenfield projects in the survey stating that the investment involved a relocation of production – versus 13 per cent in the case of M&As.

The survey suggests that greenfield investors may more often have expansion plans than M&As. In the case of greenfield investors, 90 per cent of respondents surveyed stated that they expect the project to be significantly larger in five years' time. For M&As, the respective figure was 68 per cent. This puts into perspective the allegation sometimes made in the literature that M&As do not add to the capital stock of a country (see, for instance, UNCTAD, 1999).

Conclusions

This note used survey evidence to illustrate the difference – in terms of investor motivation and impact on the host country – between greenfield investment and M&As. The results point to a number of systematic differences, some of which may be significant for policy. Table 12 provides a summary of results.

Table 11. New products versus relocation

Location	Greenfield			Share of acquisition in total (Per cent)
	Acquisition	Production	Distribution	
New production line/brand	7	3	-	70.00
Expansion of firm's total production capacity	45	31	8	59.21
Relocation of production of existing product	8	17	-	32.00

Source: EBRD.

The note provides some elements of judgement to address the question whether host countries should have a preference for either mode of entry of FDI. Thus, some host countries prefer greenfield investment over M&As, suspecting that M&As merely involve a change in ownership of the acquired assets, and that there is no new addition to the capital stock or the productive capacity of the host country. Greenfield investment, in turn, is seen to enlarge directly existing supply capacity, create new jobs and increase competition in the market. In addition, as many markets in the formerly centrally planned economies were heavily monopolized, there is a perception that existing monopoly positions might be strengthened through M&As.

Nevertheless, economies in transition can derive large gains from M&As. Even though M&As do not necessarily create new assets directly, survey evidence shows that most investors engaging in M&As have capital expansion plans. M&As, like greenfield projects, can also offer access to technologies that local firms do not possess. In addition, this note has illustrated that M&As have a more developed network of local and regional suppliers, whereas greenfield enterprises rely more on imported supplies. With greater linkages in the case of M&As, there is greater potential for spillovers of FDI to be larger than in the case of greenfield investment. ■

Table 12. Summary of the main findings

Findings	M&As	Greenfield investment
Basic characteristics		
Total capital value	Typically smaller	Typically larger
Capital commitment by foreign parent as a share of total equity capital	Typically smaller	Typically larger
Turnover	Typically larger	Typically smaller
Employment	Typically larger	Typically smaller
Role	Almost always production-oriented	Relatively more likely to be distribution-oriented
Control mode	More likely to be a joint venture	More likely to be under full foreign ownership
Status of project	Relatively more likely to be abandoned	Relatively less likely to be abandoned
Determinants		
Motivation	Market access the most important consideration; production costs of relatively less importance.	Market access the most important consideration; production costs typically also quite important.
Costs	Skilled labour costs are a relatively lower share of production costs	Skilled labour costs are a relatively higher share of production costs
Productivity of labour	Skilled labour productivity relatively lower	Skilled labour productivity relatively higher
Impact		
Supplier/customer relations	Relatively greater local content Relatively more extensive relationships with local/regional suppliers and customers	Relatively less local content Relatively less extensive relationships with local/regional suppliers and customers
Expansion plans	Have expansion plans relatively more frequently	Have expansion plans relatively less frequently

Source: EBRD.

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BOOK REVIEWS

Regions, Globalization and the Knowledge-based Economy

John H. Dunning (ed.)

(Oxford and New York, Oxford University Press, 2000), 506 pages

This voluminous book offers a valuable synthesis of new perspectives on the changing face of globalization in the context of the “knowledge-based economy”, particularly with the changing role of the localization of activities by TNCs. John H. Dunning has, again, pulled off a remarkable effort by forging a comprehensive and consistent message from a total of 18 chapters looking at this broad subject from a range of different angles.

In many ways, the analysis of this book tries to accommodate the contrasting forces of globalization and the increasing importance of the local environment for economic activity. An attractive feature is the clarity with which the book communicates the message that the positive impact of globalization is not automatically given. Whereas, in the past, too much time was spent on driving home a simplistic message, this book helps to improve our understanding about how structures and policies at various levels crucially shape the outcomes of globalization, for regions, nations and localities. Partly through the decompartmentalization of FDI into different categories, and partly through the examination of locational determinants, it characterizes nicely the conditions under which FDI is likely to help in upgrading and refining the locations in which they invest so that they grow into blossoming centres of excellence in specialized activities. It tries to draw both policy lessons and implications for research.

One key aspect of location analysed in this book is the relationship between FDI and regional integration. As pointed out in chapter 5 by Magnus Blomström, Steven Globerman and Ari Kokko, the impact of regional integration on FDI depends on the scope of environmental change, coupled with the strength of the locational

advantages. In chapter 6, Dunning convincingly demonstrates that the European integration process has had an extensive impact on FDI, although it has varied considerably across countries within the region, as well as between insiders and outsiders.

The book conveys well the message that there are good reasons for policy makers at different locations to understand better their specific assets, and to attempt to master the interplay between increasingly mobile knowledge-intensive assets and the less mobile factors that form the truly special advantages of their specific locations. In chapter 3, David Audretsch usefully elaborates on the expanded room for local specialization and for enabling policies pursued by local authorities. H. Peter Gray and Dunning point to the potential virtues of macro-regions in allowing the local levels to play such a role. As noted by the editor, however, more remains to be done in examining the interplay between policy making at different levels. It is easy to proclaim loudly the need for local strategies, but how can this be made to happen, and what is the appropriate balance between local and national responsibility? When, for instance, ten politicians from neighbouring municipalities unilaterally travel to Silicon Valley in an effort to attract venture capital, this is likely to be a costly and ineffective use of public means.

Another area that could have been addressed more extensively, especially in a book that is trying to diffuse a better understanding of these issues to a broad audience, is the issue of transition costs and dealing with the losers of the knowledge-based economy and globalization. Although Dunning actually does plead for the importance of further examining local effects under various conditions, the book does not really help to convey a clear understanding of why there is such a strong concern about globalization. One of the exceptions is chapter 10, in which Gary Herrigel points to the presence of losers among individuals who are unable to adjust, and rightly calls for action not only by local policy makers but also by national and European Union actors to deal with the problem. It is important to clarify cause and effect, however. Policy makers should foster favourable conditions for learning and restructuring, which becomes doubly important as it can help obtain the benefits of the knowledge-based economy and FDI. They should also help to mitigate transition costs, but that does

not mean that things would have been better in the absence of globalization. The phenomenon is too often identified as the culprit for problems for which it is in no way responsible.

As the book is voluminous, it would have been important to put over some of the messages more crisply. One example is chapter 2, which, while making some important points (such as shifting attention from a simplistic view of information to a more nuanced and complex understanding of different kinds of knowledge) is somewhat general and sweeping.

Finally, publishing a long book takes time, which inevitably leads to certain lags in data and other empirical observations. The late 1990s saw an explosion of new arguments and debates on the knowledge-based economy and globalization, reflecting important shifts in investment behaviour, as well as in the performance of different economies. Unfortunately, virtually no empirical data after 1996 have been included. Furthermore, the book has little to say on how globalization has interacted with information and communication technology, changes in the innovation process, and the growing importance of intangible assets, to name but a few examples, in the context of an increasingly diverging economic performance of different countries in the late 1990s. Related to this, the book touches little on the fact that FDI flows to the developing world have tailed off. This poses some additional issues and makes it important to underline that FDI is not on the increase everywhere.

Thus, there is more to be done to link the knowledge-based economy, FDI, economic performance and policy messages. It would have been stimulating to have seen even more of these issues in this book, but, then again, it already represents quite an achievement and is recommended reading for anybody interested in these questions.

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***Global Development Finance: Analysis and Summary
Tables: Building Coalitions for Effective Development
Finance***

The World Bank

(Washington, D.C., The World Bank Group, 2001), xiii + 275
pages (xiii + 135 pages of text + 140 pages of appendices)

The post-World War II architecture of global financial institutions was designed to enhance a multilateral approach to economic development and its associated activities. Thus the Bretton Woods institutions, of which the World Bank is one of three pillars, were conceived to facilitate this task. Nothing could be more helpful to the promotion of the underlying cause than information. More than money and more than grandiose projects, it was, and continues to be, information that enhances these goals.

Over the past six decades, therefore, the Bank has been in, *inter alia*, the information business. And it has been generous enough to share some of this with the outside world. In 1978, the Bank began publishing its annual *World Development Report*. A novel resource at that time, the publication soon became a useful and handy reference on data and analysis for development scholars, practitioners and governments.

The tradition of publishing data and information has continued, and indeed proliferated, to this day. *Global Development Finance (GDF)* is one of the Bank's more recent publications. Formerly published as *World Debt Tables*, *GDF 2001* consists of two volumes: *Analysis and Summary Tables* and *Country Tables*. The former contains analysis and commentary on recent developments in international finance in developing countries with a special focus on the global financial crisis. It also includes tables for countries and regional and analytical groups.

This review focuses on the first volume, particularly its relevance to foreign direct investment (FDI). Of course, the report has a broader scope, i.e. international financial flows to developing

countries. Its twin goals are to paint a quantitative portrait of financial flows (including FDI) and to provide a background analysis that can assist lenders, borrowers, and observers to better understand these flows.

Broader in scope than UNCTAD's *World Investment Reports* (*WIRs*) that focus exclusively on FDI, *GDF 2001* places FDI in the broader context of financial flows. This finance focus also means that readers can get a tighter grip on how flows of capital affect the balance of payments, economic development and policy-making in developing countries. These resource transfers from rich to poor countries create investment opportunities and influence economic development in a number of ways, including improvements in institutions and policies. *GDF 2001* suggests that international financial flows are more valuable than traditionally thought, and that the prospects for using them more effectively continue to improve.

GDF 2001 comes as the global economy, and particularly developing countries, are coping with the cyclical economic slowdown that began in 2000. Facing severe domestic imbalances to begin with, many developing countries can ill afford the ensuing external shock.

Chapter I assesses developing countries' prospects under this global slowdown. The second chapter discusses trends in private capital flows. While discussing net resource flows, the report observes that "FDI flows to developing countries remain resilient through the financial crises even though they had . . . begun to level off their rapid growth during the early to mid-1990s. Some of the factors that had contributed to high levels of FDI, such as M&As in east Asia and large-scale privatization in Latin America have since largely played themselves out." (pp. 35-36).

The chapter echoes UNCTAD's findings and policy recommendations for reform of FDI regimes.¹ Drawing upon data from UNCTAD as well as its own, this chapter echoes the theme of

¹ See *WIR2000 and 2001* (UNCTAD, 2000a and 2001a), as well as the *Investment Policy Review* of a half-dozen countries, especially Egypt (UNCTAD, 1999a) and Ecuador (UNCTAD, 2001c). (See also UNCTAD, 1999b and c, 2000b and 2001b.)

WIR2000, namely the rapid and accelerating growth of FDI during the 1990s. Unfortunately for some developing countries, it notes that:

“Industrial countries account for much of this upsurge in activity: their share in world FDI flows has risen from 65 percent in 1994 to an estimated 84 percent in 2000. The share of developing countries in global FDI flows has fallen correspondingly” (p. 37).

The subject of international capital flows and economic growth is treated at length in chapter 3, followed by a chapter on “Making Aid and Debt Relief More Effective”. The fifth and final chapter deals with effective use of development finance for international public goods.

Six statistical appendices give detailed data on topics ranging from debt burden indicators to privatization and commodity price prospects. These are all useful for the interested reader. Appendix 6 deals with commodity prices; in view of the recent global slow down, it might be instructive to look at the impact of oil prices, as seen through the eyes of GDP data. It is said that “Petroleum prices rose to a 16-year high of \$28.20 per barrel in 2000 from an average of \$13.10 per barrel in 1998” (p. 215). The report adds in the same appendix:

“Oil prices rose 56% in 2000, to an average of \$28.20 per barrel. This level is more than \$10 above the average prices over the past 14 years, but real prices are less than half of their 1980 peak” (p. 222).

Two points strike this reviewer, one minor and the other less so. First, while both assertions may be technically right, it is somewhat awkward to use two different years as reference points (14 vs. 16). More importantly, it would be highly useful to have longer time series data. Such information could not take much more space and would certainly add to the usefulness of the report for reference purposes. The same can be said about other commodity prices, since most commodities have long term impact on producers and consumers alike, and projections of the future can be made more accurately with longer time series data. Of course such data can be obtained

from other sources. Nonetheless, *GDF 2001* is a useful publication helpful to governments, economists, investors, bankers, and students of development economics.

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State Institutions, Private Incentives, Global Capital

Andrew S. Sobel

(Ann Arbor, Michigan, University of Michigan Press, 2000),
287 pages

During the last third of the past millennium, cross-border capital flows reached unprecedented levels. Various factors contributed to this phenomenon. Business activity was becoming increasingly global. National barriers to capital flows were reduced. Formerly closed and controlled economies were adopting free market practices. New capital instruments providing new users of capital and new lenders were created. New financial intermediaries, particularly mutual funds specializing in foreign markets, contributed to an increase in the amount of funds that could be loaned.

Although global capital markets have thus become more varied and complex, capital still can be classified as either public or private. Suppliers of capital either are public (governments, agencies, etc.) or private (financial intermediaries, corporations, etc.) entities. Likewise, users of capital are either public or private entities. Why these entities choose to go beyond their home base to lend or borrow has been, and continues to be, the subject of a large body of research. Much of this research is focused essentially on two kinds of questions: Why does an entity want to lend capital overseas? And, why does an entity want to access capital from a foreign source? While it is acknowledged that governments influence the flow of capital in global capital markets, exactly how that influence manifests itself is not frequently studied.

This book is an important, intriguing and innovative addition to that research on global capital markets. It is important because Sobel approaches the issue as a political economist rather than a financier or strategic planner. As a result, he is able to combine an understanding of the financial and strategic issues of transnational financial transactions with knowledge about how political issues influence those transactions. What is particularly intriguing about Sobel's book is the way he addresses uncertainty and risk.

Anyone who has studied or been involved with the global capital market knows that there are significant national differences in

both access to it and participation in it. One of the factors underlying these differences is the combined effect of risk and uncertainty. This risk and uncertainty is imbedded in the particulars of the projects in which capital is being used and in the influences of forces outside the control of the lenders and borrowers affecting the allocation of capital and the distribution of returns. One of the most important and pervasive external influences is commonly referred to as political risk. Political risk is generally acknowledged to exist, and it is factored into the decisions to lend or borrow capital across a national border through various measures that combine quantitative and qualitative analysis. It also is generally acknowledged that political risk causes distortions in the way global capital¹ is distributed across nations. Countries with “good” political risk tend to get more capital than countries with “poor” political risk. And while qualitative differences between “good” and “poor” political risk are identifiable, just how these differences distort the distribution of capital is rarely addressed. The contribution of Sobel’s book is that it addresses directly the influence of state institutions (politics) on the decisions of lenders to extend capital outside their national borders, as well as the ability of borrowers to access capital that originates in another country.

Sobel does this in a systematic way. First, he discusses two commonly used measures of political risk, ratings from *Institutional Investor* and *Euromoney*. Because these rating systems use similar approaches and datasets to derive their respective ratings of country-specific political risk, they should theoretically yield similar results when used as an explanation for the distribution of global capital. Sobel tests this by regressing one against the other, using as the dependent variable the total of foreign and international intermediated and disintermediated borrowing as reported by the Organisation for Economic Co-operation and Development.² Not surprisingly, differences in allocation are found. Sobel attributes these differences

¹ The term “global capital” in this review refers to capital that is used in one country that has its origin in another country.

² Sobel limits the domain of global finance to all international (e.g., eurobonds) and foreign debt instruments in medium to long term intermediated and disintermediated markets. An intermediated market is one in which an entity or entities stands between the original supplier of capital funds and the ultimate user of capital funds. A disintermediated market is one in which there is a direct relationship between supplier and user. Borrowers are public and private entities. Data for the years 1982 to 1991 are used, and developed and developing countries are treated separately.

to two primary factors – the lack of perfect information and uncertainty. The source of both factors lies in politics and the political arena, or, in Sobel's terms, state institutions. State institutions – the way they are organized, the way power is distributed, and the rules and regulations they produce – exert their influence two ways. First, they define the environment in which borrowers are able to access global capital and use it. Second, they determine how foreign lenders can gain access to local borrowers. Because the measure of this influence involves a great deal of qualitative analysis, it is not surprising that differences in interpretation between *Institutional Investor* and *Euromoney* could arise. Thus, the more quantitative analysis one can bring to understanding the influence of state institutions on capital flows, the less likely these interpretive differences will appear.

The second approach Sobel uses to build a better understanding of the influence of state institutions on global capital flows is to divide States into two components, i.e. regulatory States and participatory States. As Sobel sees it, a regulatory State “defines property rights, contract procedures, and mechanisms of exchange and allocation” (p. 163). In essence, it determines the legal and regulatory environment in which lenders and borrowers of global capital must function. In contrast, a participatory State “defines who participates, the nature of that participation, who has what rights, the extent of political and civil freedoms in society, and the vulnerability of the regulatory state to political pressures” (page 163). The participatory State, then, determines how accessible global capital markets are to local borrowers, and how freely lenders of global capital can expect to be able to participate in local economies.

After identifying these two components of the political arena, Sobel then describes how they can be measured. Here Sobel relies on data collected by organizations that specialize in assessing country risk, such as the *International Country Risk Guide (ICRG)* and *Business Environment Risk Intelligence* reports (*BERI*). While both provide quality evaluations, *BERI* covers only 50 countries and does not include some of the emerging economies of Eastern Europe. The *ICRG* includes five variables – government repudiation of contracts; rule of law; risk of expropriation; corruption in government; and bureaucratic delays – that Sobel feels correspond to characteristics of the regulatory State. Each of these measures carries a measure on a scale from zero to six, with higher numbers representing lower risk to the lender. Because

there is an element of multicollinearity in these variables (they overlap in what they measure), Sobel adds each of the five scores to get a combined measure for the regulatory State.

Likewise, outside studies on political freedom and civic liberty are used to develop a measure for the participatory State. Sobel uses Freedom House's *Comparative Study of Freedom*, which looks at what is actually occurring inside a country rather than what the government's intentions or constitution say should be occurring (see p. 170). In this study, political freedom addresses the ability of people to participate freely in the political process, and civic liberty looks at how freely people can develop views, institutions and personal autonomy from the State. These, then, are consistent with the way Sobel characterizes the participatory State. As with the *ICRG*, he adds the various scales used in the *Comparative Study of Freedom* to create the measure for the participatory State. Here, the scale is from one to seven, with lower numbers corresponding to less risk.

Having identified measures for the regulatory and participatory states, Sobel then goes on to model their influence on capital flows. The dependent variables are the same as those in the regressions of *Euromoney* and *Institutional Investor*, but this time he concentrates on developing countries because he found little variation in the measures of the regulatory and participatory State when applied to developed countries. Anyone who has worked with developing country debt flow data knows that there are significant problems regarding consistency, reliability and accuracy both across countries and over time. This makes it difficult to assess clearly solid relationships between intended explanatory variables and the size of the debt flow. Sobel addresses this problem in a novel and unique way. First, he asks the question: "Has a decision to lend been made?" If the answer is "yes", as evidenced by a flow of capital, the next question is: "How much should be lent?", as evidenced by the size of the flow. Sobel found that this two-step approach gets rid of some of the noise in the data and strengthens the statistical analysis.³

³ It is not the purpose of this review to detail the specifics of the statistical analysis. As one who has worked with developing country debt data and has experienced the difficulties of interpreting results across countries over time, this reviewer feels that Sobel's approach has merit and he should be lauded for it. It will be left to the expert statisticians to argue its ultimate applicability to explanations of debt flows.

The results of the analysis are intriguing. As expected, Sobel found that “economic and political differences in national contexts account for a substantial portion of investors’ behavior” (p. 190). Also, not only does the borrower’s nationality (e.g. the regulatory and participatory State) play a role independent of the proposed enterprise, but these two components of political risk also influence investors in different ways. As Sobel puts it: “the regulatory state exercises its greatest influence endogenous to calculations of country credit risk, whereas the participatory state operates exogenously to estimations of country credit risk” (p. 190). Because traditional evaluations of country credit risk overlap with estimations of the regulatory State, understanding the relationship between the participatory State and capital flows thus should enrich our understanding of why capital flows in global capital markets the way it does. Furthermore, Sobel found that those borrowers who came from more democratic systems enjoyed greater access to global capital markets than those borrowers from less democratic systems.⁴

How can the results of Sobel’s work be used and by whom? Certainly, the separation of political risk into the regulatory and participatory States adds another variable that can be used by those who are trying to determine more precisely the factors that lie behind global capital flows. It is also useful to those who extend capital to borrowers, as it helps delineate more clearly the risks of lending to different countries through global capital markets. In addition, Sobel’s verification of the relationship between access to global capital markets and democratic institutions can be used by policymakers in countries that are trying to make themselves more attractive to global lenders. This is where the idea of the participatory State is useful. The accessibility of local borrowers to global lenders is in large part determined by those mechanisms that allocate capital – local banking systems and capital markets. As a result, the more “free” or “open”

⁴ Some analysts, such as those in the World Bank or International Monetary Fund who push for economic and political reform, probably are not surprised by this. Nor probably are policymakers in the democratizing countries of Eastern Europe, Latin America and Asia who find a more receptive audience for their borrowing needs the more they reform their economies and political systems. Sobel’s contribution here is the quantification of what might appear to be an otherwise mundane conclusion.

the financial infrastructure in a country is, the greater will be the access to global capital markets. Policymakers in developing and transition economies should view this as an important lesson.

However intriguing and innovative Sobel's work is, it is not without weaknesses. Its first weakness is in the fact that it is hard to apply it to non-financial transnational corporations (TNCs). By focusing solely on intermediated and disintermediated borrowings, he ignores one of the most significant forms of cross-border capital flows, foreign direct investment (FDI). Because political risk is also a factor in the decision to engage in FDI, not addressing it (except to acknowledge that it is an alternative form of involvement in global capital markets) leaves Sobel's work half full.

Secondly, for financial TNCs, not including equity investment is also a weakness. Equity investment has become a significant component of global capital flows, particularly in the latter half of the 1990s. Because equity investments are highly sensitive to perceived changes in the investing environment, their omission from the analysis is unfortunate. This omission, however, is probably more due to the years included in the study, 1982 to 1991, than a conscious oversight.

A third weakness is the lumping together of both public and private borrowing in the data. Public and private borrowers have different needs and different uses for capital, and as a result pose different sets of risks for lenders. A public sector borrower has different access to resources to repay the loan than does a private sector borrower, and a public sector borrower has different needs for the capital being loaned than does a private sector borrower. Sobel's analysis would treat equally a country that has an 80/20 mix of public to private borrowing and another country with the same level of borrowing but an exactly opposite mix of public and private borrowing. This different mix of borrowing, however, may be a significant reflection of the economic and political environment (e.g., the latter is more open to private sector development and all that implies) that would be overlooked in Sobel's analysis.

A similar problem occurs from the combination of intermediated and disintermediated borrowings. In a disintermediated transaction, all of the risk is incurred by the lender, whereas in an

intermediated transaction the risk can be said to be diffused. The willingness to engage in a disintermediated transaction therefore implies a different attitude toward risk by the lender and a different assessment of the riskiness of the borrower. As with the public and private sector distribution example above, an 80/20 mix of intermediated versus disintermediated borrowing and a 20/80 mix of intermediated versus disintermediated borrowing convey different messages about the risk environment.

Another problem is Sobel's use of population as a proxy for market size in his analysis to show how capital is distributed globally. Clearly, population size and market strength are two separate things. Sobel included population to help show that global capital is not distributed proportionally, but this is something that did not need to be "proven" to anyone who has been studying, analyzing or working in global capital markets. While this may appeal to a political economist-type audience, it weakens the robustness of the analysis for others.⁵

The last weakness is the time span of the study, 1982 to 1991. Given how data from developing countries are aggregated (reliable data go up to about two years prior to the publication dates of sources such as the World Bank's *World Development Indicators* or the *International Financial Statistics Yearbook*), the complexity of his statistical work and the copyright date of 1999, this time frame probably is the best Sobel had to work with. Still, it leaves out a period of significant events in global capital flows: the continued emergence of formerly centrally planned economies in Eastern Europe, additional debt problems in Mexico, and a nearly catastrophic debt crisis in East Asia. All of these have had and continue to have an effect on the allocation and distribution of capital through global capital markets. It would be extremely interesting to see a revision of Sobel's work that includes most, if not all, of the 1990s.

⁵ Roughly a third of the book is devoted to a description of global capital markets, who is participating in them, their history in the early and latter parts of the twentieth century, how they are structured, and how much they have changed in the last twenty or thirty years. Again, this may be interesting to a political economist audience, but it adds little for those who have been actively involved in global capital markets as an analyst or practitioner.

Despite these weaknesses, Sobel's work is worth examining. It adds to the understanding of the influence of politics on global capital flows, and it will give those who make the decisions to extend loans additional variables to consider. It also will give those who are borrowing or who want to borrow the beginnings of a blueprint to make themselves more attractive to those who lend.

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El boom de la inversión extranjera directa en el Mercosur

Daniel Chudnovsky, editor

(Buenos Aires, Siglo XXI de Argentina Editores and Red Mercosur, 2001), ... pages

The Southern Common Market (Mercosur)¹, and in particular Argentina and Brazil, rank high in the list of emerging economies that attracted large amounts of foreign direct investment (FDI) in the 1990s. As yearly average FDI flows rose from less than \$1,600 million in 1984-1989 to more than \$40 billion in 1997-1999 (admittedly this increase was due mostly to the privatization of utilities in Brazil) Mercosur's share in worldwide FDI inflows rose from 1.4 to 5.9 per cent. Transnational corporations (TNCs) strengthened their presence in all the four Mercosur countries, turning their economies, particularly those of Argentina and Brazil, into the world's most "transnationalized" in terms of the sales and exports by foreign affiliates.

FDI was expected to contribute to the success of each country's structural reform programme, by accelerating technological modernization, by increasing exports, and by financing the deficit in the balance of payments resulting from exchange rate stabilization. However, as of the middle of year 2001, the whole Latin American region is confronting a severe slowdown, if not an outright crisis, and doubts are expressed increasingly whether it was worth embarking on the experiment in economic reforms ten years before. The book edited by Daniel Chudnovsky of the Centro de Investigaciones para la Transformación (CENIT), a leading think-tank in Buenos Aires, presenting the results of a project conducted in the four Mercosur countries with support from Canada's International Development Research Centre, is therefore a timely contribution to this debate.

In this review, the focus is on the dense opening chapter, summarizing powerfully the evidence presented in the four country studies (which themselves have an almost identical framework, making comparisons easier). Possibly the most important conclusion that the

¹ Argentina, Brazil, Paraguay and Uruguay.

authors draw is that, despite a dramatic change in the policy environment, the domestic market and its growth perspectives remain the main factors attracting FDI. The situation is hence quite the same as that prevailing under import substitution industrialization, although this time the reference market is Mercosur, particularly in the smaller economies. A partial exception is Brazil, where some well-established local companies have been taken over by large TNCs interested in acquiring strategic assets to strengthen their global competitive position.

While market-seeking strategies have been dominant, there are some examples of FDI accompanied by significant export growth, too. But resource-seeking investments play an important role only in Uruguay, despite the fact that there has also been a sizeable increase in mining FDI in Argentina. Interestingly enough, TNCs do not show a greater propensity to export than national firms do, while they tend to import more. Thus, although FDI flows have been less volatile than foreign portfolio investment, their increase has been accompanied by high profit repatriation. Indeed, in the case of Argentina, the authors estimate that the net impact on the balance of payments has been insignificant.

Government policies, manifesting a “pro-FDI” bias, have been an additional factor attracting FDI. It is important, however, to distinguish between two different types of policies. The first type involves the adoption of investment-friendly policies and rules, a change that contributes, in principle, to an increase in overall efficiency, insofar as it does not introduce distortions. The second type results in more incentives, in order to convince prospective investors to locate in a certain country or location. In the absence of clear Mercosur rules in this respect, it was first Brazil that resorted widely to competition-distorting incentives, especially in its automotive industry, followed later on by other Mercosur countries. The authors also note that, while investment incentives have mostly sought – with mixed results – to create employment and increase exports, authorities have given insufficient attention to other aims, such as reinforcing backward linkages with suppliers, supporting innovation activities, or favouring human resources training. It is not by accident that foreign affiliates still rely heavily on imported inputs (and in some cases final goods) from developed countries.

The main finding of the research project is therefore that FDI boom in the 1990s made limited contribution to the economic development of Mercosur countries. The authors however end on a more positive note. They argue that the boom is recent and, provided macroeconomic and institutional stability is preserved and markets grow, the positive impacts of FDI should eventually materialize. In this context, effort must be made to improve the quality of policies, both by reducing remaining distortions – in particular barriers to product market competition – and through specific policies to ease the shortage of finance, stimulate the use of qualified human resources, support export activities, and improve technological, productive and organizational capabilities in national enterprises in general, and small and medium-sized enterprises in particular.

Unfortunately, the events in 2001 cast serious doubts about the sustainability of the macroeconomic and institutional basis of that scenario. Moreover, the authors' suggestion to tailor policies towards FDI favouring greenfield investments over cross-border merges and acquisitions is very controversial. Besides the risk of falling foul of World Trade Organization rules, this would contradict the overarching goal of improving the functioning of markets, especially that of the market for corporate control. If indeed there is an area where this otherwise excellent research could have produced further evidence, it is exactly corporate governance. It could have been examined whether foreigners have more respect for minority shareholders' rights than traditional *grupos*. If this is the case, they will contribute to lowering the cost of raising capital. The fact that the reader is left hungry for even more research in this area and others – for example why the behaviour of Argentine and Brazilian firms is so different from that of extra-regional investors remains unexplained – however, is in itself a recognition of the quality and timeliness of this book, which hopefully will capture even wider readership once translated into English.

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***Greening the Firm: The Politics of Corporate
Environmentalism***

Aseem Prakash

(Cambridge and New York, Cambridge University Press,
2000), 181 pages

By explicitly focusing on beyond-compliance approaches, this book provides an intriguing twist to the analysis of corporate environmentalism. The internal dynamics of the firm, which appears to drive corporate behaviour with respect to the environment, has also been studied here. In addition, the book is compelling reading in terms of the details on the so-called internal dynamics of the firm's environment behaviour. The analysis on the intra-firm dynamics and external competition providing checks and balances to irresponsible environmental behaviour also makes it worth reading.

Unfortunately, the distinction the author tries to make between the internal dynamics of the firm and external factors is not fully convincing. He should have been more critical towards the role of the institutional environment in firm practices, as the mere presence of an environmental management structure (such as an auditing arrangement) is not a guarantee for better environmental performance.

The author should have paid more attention to, and should have elaborated more, the discussion on corporate policies – and, more importantly, practices – in the *foreign affiliates* of the two firms studied in the book. It is in this segment, especially in developing countries, that many of the established institutional structures for environmental management start breaking down. The reader may also miss a more detailed discussion on what is now known on supply chain management. Indeed, this area would provide one of the most important tools to judge the environmental commitment of companies. There is enormous potential for improving environmental performance along the supply chain, making full use of the purchasing power of consumers, businesses and the public sector, often the biggest, and sometimes the only, customer of transnational corporations (TNCs).

“Supply chain management” makes suppliers part of what can be called the “environmental footprint” of firms. In this case, it is not ownership that matters, but the creation of “green” business and consumer networks across national borders.

“Greening” the supply chain is a matter of shared responsibility and cooperation. Some companies insist that their suppliers conform to their rigorous in-house environmental standards. Others have product stewardship programmes that include the design, manufacturing, distribution, use, take-back, disassembly, reuse, recycling and ultimate disposal of constituent parts and materials of all affiliates and suppliers. TNCs also have an advantage of being able to train input suppliers in changing their production processes to exploit these market opportunities. Notable examples here are the contributions of TNCs to help their suppliers qualify for eco-labelling or the International Organization for Standardization’s (ISO) 14,000 certification.

The author is critical towards third party certification such as required by the ISO 14,000 schemes. He argues that firms are unwilling to share information or expose themselves to such procedures. Third party checking and rechecking is however an important aspect of a firm’s environmental management as several stakeholders are allowed to comment on the firm’s performance.

The reader may miss a more in-depth discussion on multi-stakeholder approaches such as the involvement of the local communities in which a plant is located. This is a regrettable omission, as most corporate approaches now tend to be sensitive to those stakeholder concerns. For example, one of the most important areas in which the Global Compact programme of the United Nations is expected to make a difference is exactly a more comprehensive reflection of stakeholder concerns.

The book appears to be out of sync with some of the environmental approaches that have emerged since the mid-1990s. Perhaps it would have been useful to recognize more explicitly the changing patterns of corporate environmentalism in this respect. While pure environmental concerns are diminishing in importance, the

twinning of environmental and social concerns is gaining ground in corporate policies. Corporate social behaviour, as well as projects on the social development of workers, including the elimination of child labour, are now increasingly combined with responsible environment behaviour. As a result, corporate social behaviour, third party certification, increase in environment litigation, multi-stakeholder approaches etc. form an important aspect of firm behaviour now.

On the whole, the book does provide an in-depth analysis of the “drivers” of corporate environmentalism. It however ignores some of the more basic contemporary concerns regarding this issue. This book should be interesting reading especially for those non-governmental organizations that are highly critical towards TNCs as it does demonstrate that, indeed, corporate profits and image building can be successfully integrated with responsible environmental behaviour.

Veena Jha

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***The Origins of the International Competitiveness of Firms:
The Impact of Location and Ownership in Professional
Service Industries***

Lilach Nachum

(Cheltenham and Northampton, MA, Edward Elgar, 1999),
241 pages

Why does economic activity locate where it does? The search for answers to this question has seen a renewed interest in the past decade in economic literature, starting with the seminal work of Paul Krugman and Anthony Venables (1990). What can be considered by now a standard answer states that location reflects a trade-off between costly transportation on the one hand and increasing returns (economies of scale) or some other pecuniary externalities (e.g. backward and forward linkages), on the other hand. While transportation costs tend to generate an economic production distributed homogeneously in the space following the location of consumers, increasing returns and externalities would lead to all economic activity located in one single place. Most models therefore elaborate an equilibrium between these two forces, in order to predict possible location patterns of firms. More recent models also apply this line of reasoning to the interactions between transnational corporations (TNCs) and domestic firms (e.g. Markusen and Venables, 1999), showing how and to what extent the location of TNC activities is affected by forces other than the traditional variables derived from the availability of tangible immobile factors of production.

And yet, notwithstanding this interest, some of the questions posed to the researchers by the empirical observations remain to be answered. In particular, how and to what extent do TNCs, driven also by ownership and internalization (rather than only localization) advantages, conform to the general theoretical predictions? And, more strikingly, how do these conclusions need to be changed when dealing with service industries, today constituting the bulk of developed countries' activity, and characterized by the unpleasant feature (to the researcher) of being undertaken at (close to) zero transport costs?

In almost 250 dense and well written pages, this interesting book, focusing on the impact of home countries on the international competitiveness of services TNCs, seeks to explain both the geographic concentration of these firms in a single or very few locations, and their uneven performance, thus providing powerful insight into this crucial field of studies.

In particular, chapters 2 to 4 focus on an in-depth examination of the advertising industry through analysing the origins of the ownership advantages of United States, United Kingdom and French firms. They prove, through sound empirical evidence and a sometimes overly simple statistical analysis, that the home country matters for the general competitiveness of a TNC. Chapter 5 to 7 expand this issue further. By using the same analytical methodology, they examine the relationship between home countries' and TNCs' competitiveness, focusing this time on the professional service industry and adding another country, Sweden, to the analysis.

Finally, chapter 8 deals with an issue often overlooked by researchers, that is the fact that even the most perfect theoretical analysis, when applied to firm-level data, suffers from the limitations embedded in the specific, often surprising, nature of each corporation. This book sheds light on this point by comparing Danish and British consulting firms and the factors leading to their different behaviour and performance.

The conclusion that home countries affect the ownership advantages of professional services firms more than any host location in which these firms operate, raises a challenge for both international business and international economics scholars. It is to be further developed how interactions between the competitiveness of TNCs and their location decision take place on the basis of differences in the location advantages of home countries, thus allowing to explain better the patterns of international competition in services industries.

As stated in the conclusions of the book:

“Geography is not dead, and national borders have not become meaningless in an economic sense, as is often

maintained; not even in a world in which the configuration of the activities of firms is increasingly based on intangible mobile assets which are exclusive to firms rather than countries, and are used by firms in whatever location they consider appropriate, as the basis for their competitive strength” (p. 201).

A point of arrival that is a good starting point for a research programme capitalizing on the extensive evidence and intuition presented in the book. As a suggestion, rather than a criticism, it should be a programme that should exploit in a more rigorous way the extensive empirical evidence collected, attempting to formalize from the existing theoretical models some hypotheses, then subject to stringent econometric testing.

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[Reviewer to provide page numbers]
- Markusen, James and Anthony Venables (1999). “Foreign direct investment as a catalyst for industrial development”, *European Economic Review*, 43, pp. 335-356.

***Globalisation of Corporate R&D: Implications for
Innovation Systems in Host Countries***

Prasada Reddy

(London and New York, Routledge, 2000), 224 pages

The aim of this book is to provide a better understanding of the impact of the globalization process on corporate research and development (R&D). It covers three major areas: R&D-related investments in developing countries by transnational corporations (TNCs), the driving forces behind this emerging phenomenon, and its implications for developing host countries, particularly in terms of building up national innovation capabilities. Although the globalization process has been widely analysed, current research has been almost entirely concerned with developed countries. A major addition of Prasada Reddy's book to current knowledge is the above-mentioned focus on the integration of some developing countries into the phenomenon of globalization of corporate R&D. The book is mainly addressed to an academic audience interested in international business and development issues.

With the exception of the analysis of factors underlying the globalization of R&D, issues are set and examined in a broad framework. In conducting the analysis, the book starts with a general discussion on global business conditions and the theoretical explanations of the internationalization of production and R&D activity. In the core chapters that follow, the situation of the developing countries is analysed empirically. To do so, Reddy uses a database developed at the Research Policy Institute of Lund University in Sweden including statistics on science and technological environments, as well as on specific R&D activities conducted by TNCs. Further empirical evidence is then provided in the chapters dedicated to case studies set in India and Singapore. These case studies are particularly important because they highlight the progress achieved by these countries, which would otherwise be overlooked had the two countries simply been grouped together with all other developing countries in one block. On the basis of this analysis, implications for innovative capabilities in the host countries and policy implications are drawn and the conclusions of the study presented.

The main argument emerging from the overall discussion relates to a major structural change in the nature of R&D activities TNCs conduct in developing countries. According to the author, the 1980s witnessed the localization of higher-order R&D activities in developing countries by comparison with a previous situation where developing countries traditionally hosted R&D related to adaptation of products and processes to local conditions. This shift is explained in terms of technology- and cost-related advantages, as major opportunities to gain access to R&D personnel, as well as to exploit the cost differentials between developing and developed countries exist in the countries under analysis. The driving forces of globalization of corporate R&D are classified as demand-side factors (e.g. convergence of consumer needs); supply-side factors (e.g. under-utilization of scientifically and technically trained workforce in developing countries); facilitating forces (e.g. improvement in information and communications technology and the emergence of telematics) breaking the geographical barriers; and international forces (e.g. homogenization of international markets and standardization of technologies for global markets) re-shaping the traditional parent-affiliate relationship into a global intra-organizational network-based management structure.

From the overall discussion two major arguments arise from the analysis. First of all, although the globalization of corporate R&D is marginal from the perspective of all TNCs as a group and all developing countries as a block, it assumes great significance from the host country perspective, where R&D activities are now located, after the relocation of labour-intensive assembly activities. In fact, the emerging re-location of R&D may open new avenues of development for host economies, where new national innovation systems may rise. Second, at a more theoretical level, unlike what was suggested by Raymond Vernon's original product life cycle model (Vernon, 1966) – namely that R&D activities are almost always carried out in the home country of the TNC – the product cycle can start anywhere in the world in the corporate system. The location of higher-order R&D investments in developing countries negates the conventional view that some countries have the competence to perform only low-technology activities. The trend proposed by the author suggests that developing countries can perform high-technology activities, although

this does not imply that developing countries can achieved advanced technological capabilities equal to the developed countries.

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Reference

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JUST PUBLISHED

UNCTAD Series on Issues in International Investment Agreements Illicit Payments

(Sales No. E.01.II.D.20) (\$15)

The bribery of foreign public officials in the course of cross-border investment and international business transactions raises foreign-direct-investment (FDI) related issues for host countries, transnational corporations (TNCs) and their home countries. This paper focuses on how international investment agreements and related instruments have addressed the issue of combating transnational bribery through international obligations by States to criminalize such transactions within their national jurisdictions. The paper begins with the identification of the principal issues that arise in connection with such criminalization. Then it takes stock of how international instruments have dealt with those issues. The definition of the offence of transnational bribery is developed in such a way as to avoid circumvention by including both direct and indirect transactions. In addition, issues arise as to how to overcome inconsistencies presented by the diversity of national legislations and a lack of efficient international mechanisms for investigation, prosecution and enforcement. International anti-bribery agreements seek to obtain the maximum possible latitude for each State party to be able to exercise jurisdiction in an investigation and prosecution of instances of transnational corruption. At the same time, they include provisions on international cooperation to minimize conflicts of jurisdiction, especially in the areas of investigation, prosecution, extradition, gathering of evidence, and seizure and confiscation of the proceeds of a transaction. Moreover, to increase the effectiveness of international anti-bribery agreements, criminal sanctions are complemented by non-penal measures such as obligations on the part of TNCs to report relevant information to shareholders, to meet bookkeeping and financial reporting standards.

Home-country Measures (Sales No. E.01.II.D.19) (\$15)

FDI transactions have three stakeholders: the TNCs, host countries and home countries. Measures adopted by home countries can affect TNC decisions regarding the selection of host country investment sites in various ways. They can take such forms as restrictions on capital outflows, general policy pronouncements, information and technical assistance, financial and fiscal incentives, investment insurance and market access regulation. A stock-taking presented in this paper shows that most developed countries have removed national restrictions on outward FDI. Their policy declarations, however, often lack specific obligations for the adoption of concrete home-country measures, especially those adopted in the framework of bilateral investment treaties. This is a major weakness as the effectiveness of policy options to increase the beneficial impact of home-country measures on FDI flows is likely to increase in line with the strength of the policy commitments, running along a continuum from hortatory declarations to binding obligations accompanied by detailed implementation plans and monitoring mechanisms. A cross-cutting implementation issue that also merits consideration is the potential extraterritorial impact that home-country measures might have in host countries, including the influence on a potential investor's decision to engage in FDI, as well as a TNC's performance, once invested.

Host-country Operational Measures (Sales No E.01.II.D.18) (\$15)

The concept of host country operational measures (HCOMs) captures a vast array of measures implemented by host countries concerning the operation of foreign affiliates once inside their jurisdictions. HCOMs can cover all aspects of investment and usually take the form of either restrictions or performance requirements. In international investment agreements, HCOMs have rarely been considered as a separate issue. More often than not, the international regulation of such measures has to be deducted from more general norms on post-entry treatment of investment. The WTO Agreement on Trade-Related Investment Measures (TRIMs), however, specifically deals with a

number of HCOMs. This paper groups HCOMs into three categories and proceeds with discussing them in the context of some of their restrictions at different international levels. The first category consists of HCOMs that are explicitly prohibited at the multilateral level, i.e. by the TRIMs Agreement; to use a traffic light analogy, these are “red light” HCOMs. A second category consists of additional HCOMs that are explicitly prohibited, conditioned or discouraged by interregional, regional or bilateral (but not by multilateral) agreements; these are “yellow light” HCOMs in the sense that negotiators of international investment agreements ought to be aware that some countries have indeed prohibited them in some agreements and perhaps would like to do so also at the multilateral level. The third category, consisting of all other HCOMs, can be called the group of “green light” HCOMs. Today, countries negotiating international investment rules need to take as given the first group of HCOMs (unless there should be a renegotiation or modification of the TRIMs Agreement). Negotiations – should they at all include HCOMs – are likely to focus on “yellow light” HCOMs. But options go beyond either covering or not covering certain HCOMs. The extent to which certain HCOMs are tied to certain conditions (e.g. incentives) or the legal nature of any coverage (e.g. best effort clauses) can introduce some flexibility.

Transfer of Technology (Sales No. E.01.II.D.33) (\$15)

This paper discusses the issue of technology transfer in the context of international investment agreements. Policies for the encouragement of technology transfer have evolved over the years and have been the subject of provisions in international investment agreements. Section I of this paper places such policies and provisions in the wider context of intellectual property laws, competition policies and performance requirements, among other things. Section II identifies two broad policy approaches to technology transfer. One is a regulatory approach, which seeks to intervene in the market for technology in order to rectify perceived inequalities. A contrasting approach puts the emphasis on the creation of conditions for a free market transfer of technology encouraged, for example, by strong intellectual property laws. Section III considers the interaction of technology transfer with other issues

covered by international investment agreements. There is a strong interaction with a host of issues such as scope and definition questions, admission and establishment, the most-favoured-nation standard, national treatment and host-country operational measures, for example. Section IV provides seven possible options concerning the role that provisions on technology can play in international investment agreements. These are considered in the light of the market for technology and the position of developing countries therein.

Investment Policy Review Ecuador (Sales No. E.01.II.D.31) (\$25)

In concert with other members of the Community of Andean Nations, Ecuador liberalized FDI policies in the early 1990s. In addition, it opened up its economy to international trade, reformed its tax and fiscal systems, and tried to initiate a privatization programme. Foreign investors responded to these (and other) changes with a surge of FDI inflows. At the end of the decade, when the country ran into a serious political, economic and social crisis, FDI proved to be fairly resilient. Nevertheless, even before the crisis, both the quantity and quality of FDI was much below Ecuador's needs and potential. The country has indeed many untapped attractions, such as abundant natural non-renewable (oil, mineral) and renewable (bananas, flowers) resources, a competitive labour force, and free or preferential access to large international markets, which, with appropriate policies, can be turned into opportunities. Success will depend on the effectiveness of the policies and actions in a host of areas, such as macroeconomic stabilization, the restoration of social consensus, the improvement of the legal framework for investment, the implementation of a viable privatization programme, the improvement of the physical infrastructure, designing policies aimed at increasing the long-term benefits of FDI, and implementing an investment promotion programme.

Análisis de las Políticas de Inversión: Perú
(Sales No. S.00.II.D.7) (\$22)

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International Investment Instruments: A Compendium.
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International Investment Instruments: A Compendium contains a collection of international instruments relating to foreign direct investment and transnational corporations. The collection is presented in six volumes. The first three volumes were published in 1996. Volumes IV and V were published in 2000. *Volume VI* brings the collection up to date for 2001 by including a number of instruments that were not included in the previous volumes.

Books received on FDI and TNCs since August 2001

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- Hornby, Win, Bob Gammie and Stuart Wall, *Business Economics* (Harlow, London and New York: Prentice Hall, 2001), 2nd edition, 456 pages.
- Karaszewski, Włodzimierz, *Przedsiębiorstwa z udziałem kapitału zagranicznego w Polsce w latach 1990-1999: Miejsce w gospodarce kraju, czynniki perspektywy rozwojowe* [Companies with the Participation of Foreign Capital in Poland in 1990-1999: Their Place in the Economy, Their Situation and Opportunities for Growth] (Torun: Nicholas Copernicus University Press, 2001), 371 pages.
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- Liuhto, Kari, ed., *Ten Years of Economic Transformation. Volume II: Markets, Companies and Foreign Business in Transition* (Lappeenranta: Lappeenranta University of Technology, 2001), 583 pages.
- Liuhto, Kari, ed., *Ten Years of Economic Transformation. Volume III: Societies and Institutions in Transition* (Lappeenranta: Lappeenranta University of Technology, 2001), 435 pages.
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- Wei, Yingqi and Xiaming Liu, *Foreign Direct Investment in China: Determinants and Impact* (Cheltenham and Northampton, Massachusetts: Edward Elgar, 2001), xiii + 192 pages.

GUIDELINES FOR CONTRIBUTORS

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C. **Figures** (charts, graphs, illustrations, etc.) should have headers, subheaders, labels and full sources. Footnotes to figures should be preceded by lowercase letters and should appear after the sources. Figures should be numbered consecutively. The position of figures in the text should be indicated as follows:

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E. **Abbreviations** should be avoided whenever possible, except for FDI (foreign direct investment) and TNCs (transnational corporations).

F. **Bibliographical references** in the text should appear as: “John Dunning (1979) reported that ...”, or “This finding has been widely supported in the literature (Cantwell, 1991, p. 19)”. The author(s) should ensure that there is a strict correspondence between names and years appearing in the text and those appearing in the list of references.

All citations in the list of references should be complete. Names of journals should not be abbreviated. The following are examples for most citations:

Bhagwati, Jagdish (1988). *Protectionism* (Cambridge, MA: MIT Press).

Cantwell, John (1991). “A survey of theories of international production”, in Christos N. Pitelis and Roger Sugden, eds., *The Nature of the Transnational Firm* (London: Routledge), pp. 16-63.

Dunning, John H. (1979). “Explaining changing patterns of international production: in defence of the eclectic theory”, *Oxford Bulletin of Economics and Statistics*, 41 (November), pp. 269-295.

United Nations Centre on Transnational Corporations (1991). *World Investment Report 1991: The Triad in Foreign Direct Investment*. Sales No. E.91.II.A.12.

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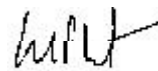
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Please do take the time to complete the questionnaire and return it to the above-mentioned address. Your comments are important to us and will help us to improve the quality of *Transnational Corporations*. We look forward to hearing from you.

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