

## **8. Analysis about Hungary's Attractiveness to Investors with Particular Regard to Foreign Direct Investments**

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*From the beginning of the 1990s Foreign Direct Investments (FDI) inflows have always played an important role in the Hungarian economy. The situation did not change even though the inflows and the stock of FDI have been decreased for the last few years. Hungary as a small open economy depends heavily on foreign capital and foreign direct investments.*

*However foreign capital and foreign direct investments inflows enter the countries under prosperous market, political, economic, social and legal conditions. These factors have a growing significance during the economic and financial crisis. Responding to the challenges of the economic recession more and more countries are seeking to improve their ability to attract capital because the foreign direct investments are defined as a key factor of economic growth. The question is which factors are improving Hungary's ability to attract capital?*

*In the first part of the study<sup>1</sup> decisive factors will be revealed contributing to a country's competitiveness and ability to attract capital. In the second part these factors will be analyzed related to the Hungarian economy. In the study we describe some problems of emerging economies such as the existence of the dual economic structure, the phenomenon of stagflation, the high tax burdens and low wages all with regard to Hungary. Furthermore it will be analyzed how the low-wage jobs are promoting Hungary's attractiveness to investors. In the conclusion our proposals will be formulated in order to retain as well as improve Hungary's attractiveness to investors.*

*Keywords: FDI, Hungary, competitiveness, economic growth*

### **1. Introduction**

In the years of the crisis countries must endeavour to increase their competitiveness in order to attract capital. The main question in our study is which countries are attracting an influx of capital and foreign direct investment? What must a country do in order to attract capital? In this study we try to answer these questions in relation to Hungary. We analyse Hungary's and ability to attract capital through foreign direct investment, and examine the principle factors involved comparing with Central and East-European countries.

Foreign Direct Investment (FDI) is a very important factor in the Hungarian economy. Some authors (Szanyi 2004, Artner 2003, Antalóczy – Sass 2002) have demonstrated that FDI grew the profitability and productivity of the Hungarian economy and was crucial to the

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recovery of the economy. The biggest problem facing the Hungarian economy is that Hungarian corporations could not connect successfully with multinational corporations.

In most cases we can say that Hungary is well placed in the field of competitiveness because it already has a high level of successful investment and the investors are mostly satisfied. At the beginning of 1990s Hungary used many methods to attract FDI, for example subventions, reduced taxes, low labour costs, and legal stability. However Antalóczy (2003) wrote that stability of economy is the most significant factor in attracting FDI in any country. Her study is based on a number of interviews and the interviewees said that nothing is as important as stability of economic policy. Those interviewed said that it is attractive when the concurrent foreign investor is in the host country too and their experiences of investment are positive. But how can Hungary still profit from FDI and how could it attract more foreign capital? This study tries to answer these questions, but it is very difficult to do so because the concept of competitiveness is used to explain a variety of factors.

The key question is what is the fundamental motivation for a firm to go abroad? Until now, there was a general consensus among the experts on the question of why multinational companies invest in specific locations. The view was that MNCs are mainly attracted by strong economic incentives in the host economies. The most relevant of these are size of market and the level of real income, with qualification levels in the host economy, the quality of infrastructure and other resources that support to specialize efficiently the production, trade policies and political and macroeconomic stability as other central indicators (Blomström – Kokko 2003). More than 100 countries provided various FDI incentives in the mid-1990s, and dozens more have implemented such incentives since then – today few countries compete for foreign investment without providing any form of subventions (UNCTAD 1996).

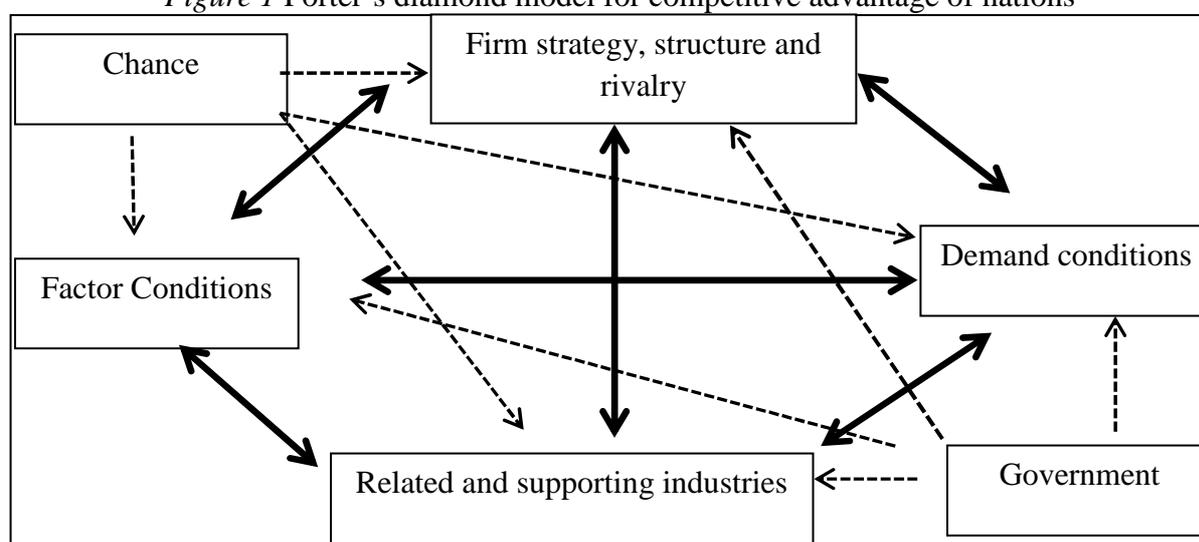
## **2. Explanatory theories of Foreign Direct Investments**

The theories explaining FDI flows were looking for an explanation of what factors influence their production in foreign countries. Working capital theory had a major impact on the development of explanatory theories of international trade. In the following article we show how the main theories explain the flow of foreign direct investment. The earlier theories (for example the Froot-Stein model) suggest that when the impact of the change in the cyclical FDI is expected to be favourable companies bring forward their investment, while investment is delayed by an unfavourable environment (Nielsen et al. 2010).

## 2.1. Porter – diamond model for countries

National competitiveness has become one of the central preoccupations of government. Yet for all the discussion, debate, and writing on the topic, there is still no persuasive theory to explain national competitiveness (Porter 1990). Porter (1990, p. 87.) believes that “*the only meaningful concept of competitiveness at the national level is productivity (...) and the ability (to be competitive) depends on the productivity with which a nation's labour and capital are employed*”.

Figure 1 Porter's diamond model for competitive advantage of nations



Source: Porter (1990)

In our study we demonstrate that it is not necessarily true, for example: Hungary has among the Visegrad countries the biggest FDI stock but we have not so high productivity than the other countries. Porter's diamond model, illustrating competitive advantage among nations includes four determinants which influence the competitiveness of states. We think so that the competitive advantage of nations is more complex and includes several factors.

## 2.2. OLI paradigm

“None of the general theories of FDI have been able to satisfactorily explain the international activities of firms. A candidate for a general theory of FDI is Dunning's Eclectic Theory, which is based on the OLI paradigm” (Moon – Roehl 1993, p. 56.).

The eclectic theory is a mixed theory and is based on transaction cost theory. The three components of the OLI paradigm are ownership specific advantage, location specific advantage and internalization specific advantage. Location specific advantage depends upon the existence of raw materials, wage levels, and the existence of special taxes or tariffs (Dunning – Lundan 2008)

Three forms of international activity on the part of companies can be distinguished: export, FDI and licensing. According to Dunning, two different types of FDI can be noted. First, that which occurs in order to establish access to raw materials. Second, market seeking investments, which are made to enter an existing market or establish a new market. If the ownership specific advantage is weak and the location specific advantage is strong then more foreign direct investment flows into the host economy (Dunning 2000). In the second part of our study we show that Hungary has rather location specific advantage (for example: low wages, well trained labour supply, middle-high productivity, low prices, opened economy therefore high-level international economy).

*“The eclectic paradigm of Dunning has more explanatory power than others because it uses more variables, not just ownership advantages”* (Moon – Roehl 1993, p. 59.).

We are not attempting to describe the often cited Vernon’s product life cycle theory and Ozawa’s phase model in detail. We only refer to the fact that Vernon’s product life cycle theory explains the flow of capital from developed countries to developing countries, and that Ozawa’s phase model explains investment factors between the developed and developing states.

### *2.3. Advanced Factors of Location*

Buhmann and his co-authors (2002) wrote in their publication about more advanced factors of location. These factors influence the decisions of company owners and have the following fields: performance, market factors, and production factors. Every field has three groups: monetary, non monetary and quantitative elements. The performance consists of productivity, costs, soft facts of performance, process goods and signed revenues. The market factors are potential profit, attractiveness of market, situation of rival companies, constraints of trade, market structure and strategy of competition. The production factors are costs, incentives, infrastructure, availability of production factors, and quality of infrastructure factors, social culture, political factors, and legal factors. Transnational or multinational companies will only invest if the host country is strong in these factors. A country's

competitiveness has a significant impact on its foreign trade policy as in Hungary too. In recent years, more and more countries have liberalized their trade policies in order to increase their ability to attract capital. Even during the years of financial crisis abolished customs duties, quotas and free passage of foreign goods, and capital were increasingly a measure of competitiveness (Blomström – Kokko 2003).

### **3. Empirical evidence**

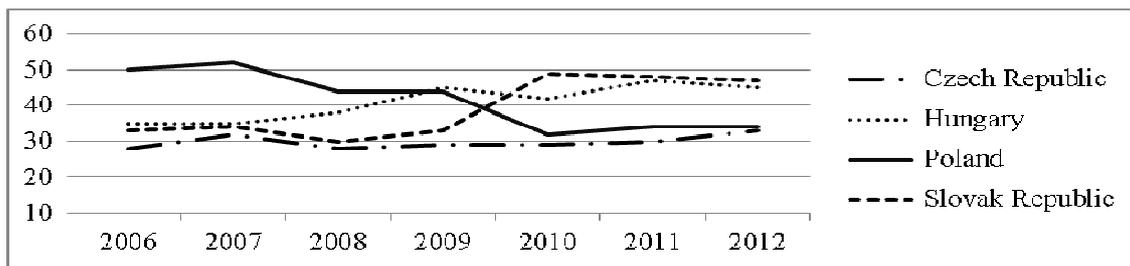
International comparisons are made with regard to countries' competitiveness using various indicators to establish a ranking. The two most well-known comparisons are those provided by the IMD and the World Economic Forum. The country competitiveness rankings are published every year, which makes it possible to examine the relative position of a country by international standards and to see which factors have improved or worsened competitive ability over the course of the past year. This study first shows the Competitiveness Rankings from IMD and then the competitiveness rankings of the World Economic Forum.

#### *3.1. IMD Competitiveness Rankings*

Figure 2 demonstrates the competitiveness of Visegrad countries between 2006 and 2012. As we can see Hungary's competitiveness is reduced during these seven years but Poland is the exemption among the Visegrad nations since its competitiveness has increased over the period in question. The period between 2006 and 2012 saw the greatest improvement for Poland. The Slovak Republic by contrast suffered the most intense reduction over the same period. The Czech Republic has similar values across the period, between 28 and 34, and did not see such significant changes. With the onset of the global financial crisis there was a drop in values for the majority of countries.

This competitiveness ranking includes the following four factors: economic performance, government efficiency, business efficiency and infrastructure. We would like to analyse the indicator "economic performance" in greater depth because we think so that this indicator is the most important.

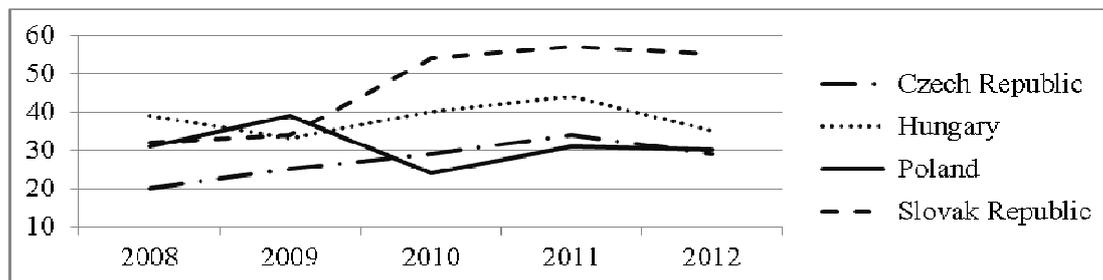
Figure 2 Overall Competitiveness Ranking in Visegrad countries (2006-2012)



Source: www.worldcompetitiveness.com

As Figure 3 shows, the Visegrad countries have very different economic performance values. Economic performance includes domestic economy, international trade, international investment, employment, and prices. In the case of “economic performance” Hungary’s rank is greatly reduced as it is in overall competitiveness. The other countries have similarly weak data. In this category of performance the Slovak Republic once again has the weakest ranking, and again in this field Poland has an improved position.

Figure 3 Economic Performance Ranks in Visegrad countries (2006-2012)



Source: www.worldcompetitiveness.com

When we look at the performances in the case of Hungary we can establish that the biggest failure is in the field of infrastructure and more moderate declines occur in the field of business efficiency and government efficiency (Table 1). The infrastructure performance includes the following factors: basic infrastructure, technological infrastructure, scientific infrastructure, health and environment, and education. One of the biggest problems in Hungary is that the R&D (research and development) in relation to GDP is too low. Figure 4 partially confirms our observation (see for example the factor “Education”). The Hungarian R&D rate was 1,20 per cent in 2011. This proportion was the lowest in 1996 and it signifies 0,64 per cent of GDP (Central Bank of Hungary). It is growing slowly from year to year but the growth remains low.

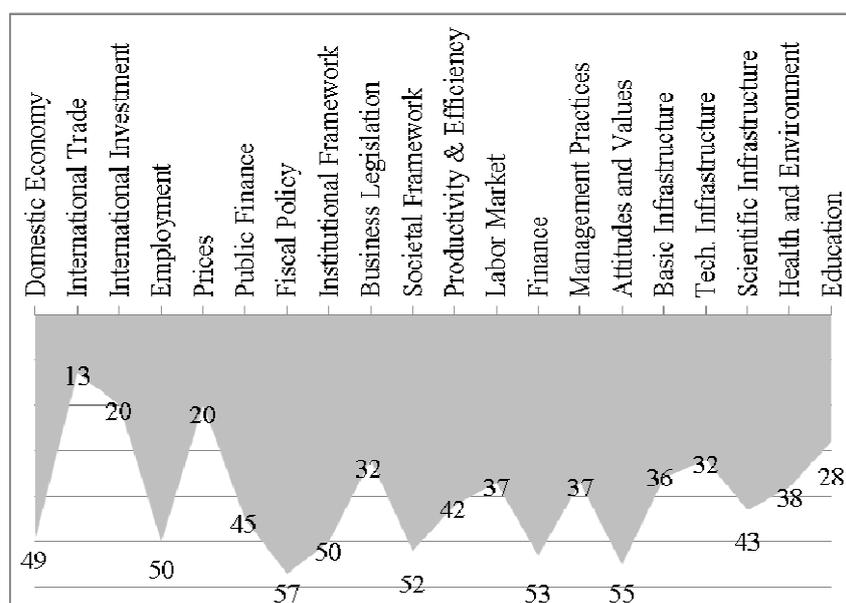
Table 1 All indicators ranking of Hungary

Indicators Ranking	2008	2009	2010	2011	2012
Overall Competitiveness	38	45	42	47	45
Economic Performance	39	33	40	44	35
Government Efficiency	47	50	51	52	51
Business Efficiency	45	52	47	50	49
Infrastructure	27	33	35	35	35

Source: www.worldcompetitiveness.com

Figure 4 presents the World Economic Forum data concerning Hungarian competitiveness. It shows that Hungary's strengths are in the fields of international trade, international investment, prices, business legislation, and education, and we have the weakest value in the fields of domestic economy, employment, fiscal policy, international framework, finance, attitudes and values and scientific infrastructure.

Figure 4 Competitiveness Landscape of Hungary



Source: World Economic Forum: World Competitiveness Online

Hungary is a small country with many neighbours; therefore international trade is important and attractive in our situation. On the homepage of World Competitiveness Online we can see the data regarding the competitiveness of Hungary. And here it was established that Hungary's competitiveness reduced. Hungary's ranking fell from 38 in 2008 to 45 in 2012.

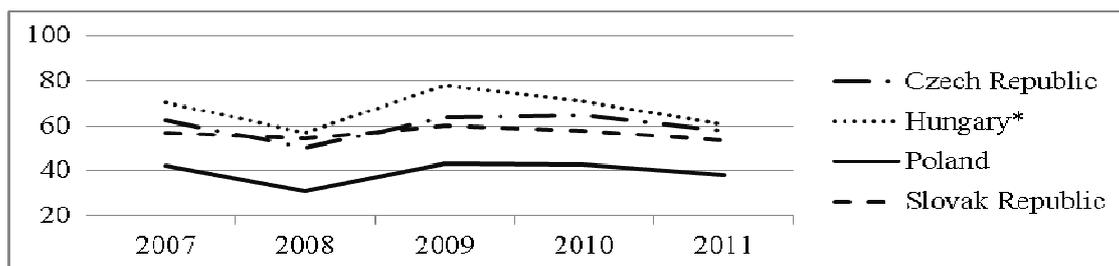
Every year the World Economic Forum produces a Global Competitiveness Report. This report provides a ranking for all countries. Hungary currently has the rank of 60.

If we analyze the absolute data from the inflow of Foreign Direct Investment, we can see that in Hungary at the beginning of the 1990s there was a big increase, and there was a further increase in the post-millennium years. Before the early 1990s there was very little FDI. At the beginning of 1990s there was a high level of privatisation and as a result there was a heavy influx of foreign capital to Hungary. Our country was very successful and a popular location for investors. Later the inflow of FDI fell, and dramatically so towards the end of the 2000s. At this time Hungary's popularity as a location for FDI fell.

Poland is exemption in absolute terms due to its size, but relative to GDP the ratio is the same as the data for other countries. When we compare the four countries' data the Slovak Republic has a lower inflow and the Czech Republic has a higher FDI inflow.

Finally when we look at FDI as a percentage of GDP, Hungary has the greatest rate of the Visegrad countries. In the years of economic crisis the data shows decreases for of these states. It demonstrates that Hungary is more open to foreign investment state that the other countries and it depends very heavily on the world economy. This data is not surprising because UNCTAD publishes a yearly working paper detailing the international rate of foreign investment for all countries and in 2004 it wrote that Hungary ranks 6<sup>th</sup> in the world of the countries most open to foreign investment (UNCTAD 2004).

Figure 5 FDI stock in per cent of GDP in Visegrad countries (2007-2011)



Source: [www.oecd.org](http://www.oecd.org)

Note: \*Hungary: Data excluding Special Purpose Entities

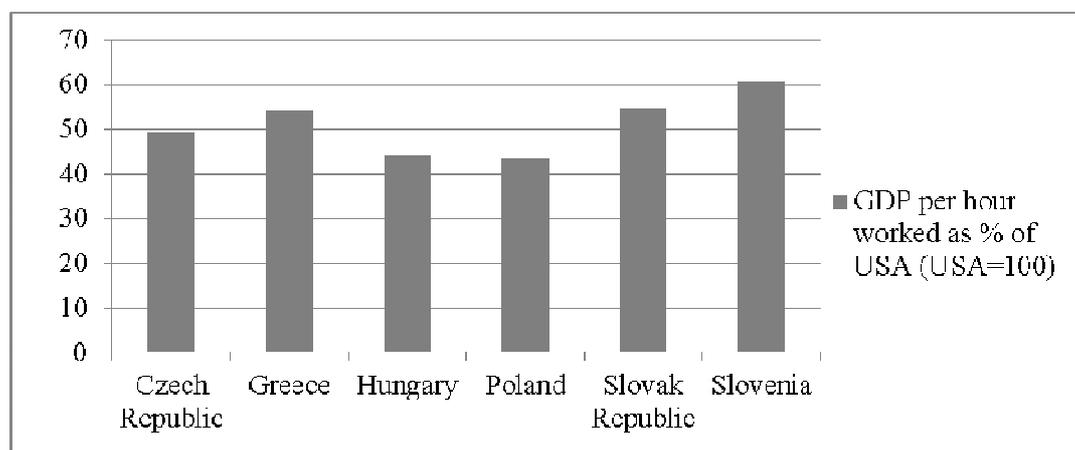
Poland the highest figures for absolute value, because it co is bigger than the other countries. In Slovakia FDI does not play such an important role as in Hungary or the Czech Republic.

Until the year 1999 a total of 19.276 million dollars FDI came into Hungary exclusive of reinvested profits. Hungary occupies a prominent position in the Central-East European

Region (Antalóczy 2003) when it comes to FDI. But what is Hungary's strategy for investment promotion? Hungary uses many methods for investment promotion. For example: tax exemption, reduced preferential taxes, subvention of government for investors. Government subvention was prevalent in the 1990s. But subvention in other European countries is lower. Hungary tries to be free of discrimination and to follow a policy of transparency.

The majority of studies about Hungarian investment promotion assess all multinational companies in the same way and do not make distinctions between the companies. The European Commission (2013) published a working paper about the Hungarian economy, growth potential and tax system on 10<sup>th</sup> April. It wrote that Hungary's recovery has been the weakest among the Visegrad countries since the 2009 recession and the marked decline of inward direct investment over recent years contributed to the stagnating total stock of net foreign direct investment. The substantial FDI investments (around 2% of GDP) into the automobile industry have already begun to improve or will improve productive capacities in the automobile sector (by some 50%) in the coming years. The rate of total investment (including domestic, foreign and government investment) has decreased to around 17% of GDP.

Figure 6 GDP per hour worked as % of USA (USA=100%, 2011)

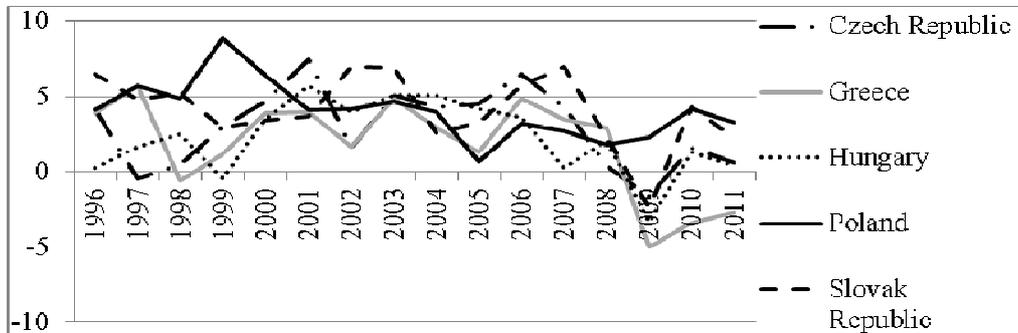


Source: [www.oecd.org](http://www.oecd.org)

Porter wrote that productivity is very important to competitiveness. Therefore we show the indices of productivity in our example: GDP per hour worked as a percentage of the figure for the USA (Figure 6). In this comparison Hungary has an unfavourable situation. Hungary

has the weakest data and Slovenia has the strongest. Figure 7 is also connected to productivity.

Figure 7 Labour productivity growth in the total economy



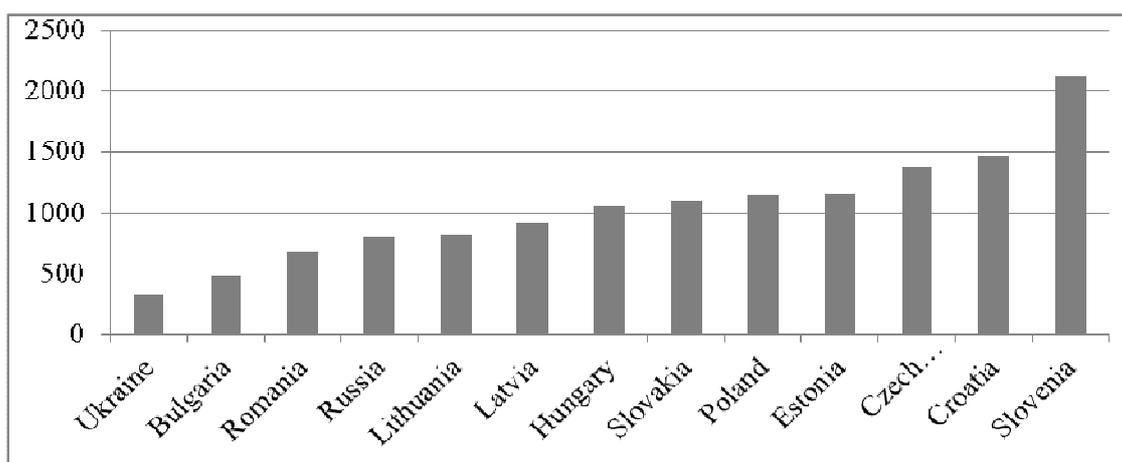
Source: [www.oecd.org](http://www.oecd.org)

Figure 7 shows the labour productivity growth in these five countries. In the early 2000s and from 2008 to 2009 Hungary could increase its efficiency. In 2009 because of of crisis the productivity of all countries, with the exception of Poland, decreased. It is very interesting that the productivity of Poland did not decrease. The bigger falling had the Slovak Republic and Greece. In the next years all the countries increased their rates of productivity. Hungary reached about 1,5% but in 2011 productivity was lower again. In comparison to other countries Hungary has average values but it is able to execute and produce to higher levels. We can see this in the earlier years where the growth of productivity was more than 4-5%.

Szanyi (2004) underlines that Hungary should be able to benefit in the fields of wages, taxes, domestic resources, domestic market, research and development (R&D) and stability of suppliers. Szanyi believes the earlier realized positive investment influences the future decisions of investors in a positive way. Hungary must bring knowledge-related competitiveness into focus and needs to establish a good image.

It is a big problem too that middle-size companies are not operating in Hungary just small-size companies and some bigger firms. The economic structure is dual: first there is a domestic part of the economy and secondly there is another part with a closed or “enclave” character. The first part is mostly developing, and not so productive and the second is developed and more productive. These parts have not connection and the developed sector can not enhance the low-developed sector.

Figure 8 Average monthly gross earnings in US\$, 2011



Source: [www.databasece.com](http://www.databasece.com)

As stated above lower wages are the one benefit of competitive advantage. When compared to other European countries *Figure 8* shows that Hungary is in the middle. The lower developed countries have lower average wages. Slovakia, Poland and Czech Republic don't have significantly higher values. In almost all countries in this region there are lower wages and this is one of their strengths from the point of view of foreign investors.

The exception is Slovenia because it depends less on foreign trade and foreign direct investment, and has a more stable domestic economy. Also in this aspect Hungary has no greater advantage than the other countries in the region.

### 3.2. Credit Rating

Finally we show the role of credit rating. International credit rating organisations have a major influence on a country's external image. These organizations classify countries according to their credit rating, and all data is based on the economic situation. If a country's credit rating is reduced it has knock on effects. This means transnational corporations may decide not to invest in the country of destination based on this information alone, when the impact of investment could be highly profitable. Hungary's credit rating has deteriorated in recent years. The three major credit rating companies (Moody's, Fitch, and Standard & Poor's) all downgraded Hungary. Hungary's long-term foreign currency debt is classified in the negative, and is projected to be negative. These facts, unfortunately, have a negative impact on investment decisions (Central Bank of Hungary).

#### 4. Conclusion

In this study we tried to analyse the competitive advantages of Hungary. Although Hungary is found in a good position regarding its competitiveness, economic performance or FDI stock compared with Poland, Slovak Republic and Czech Republic, the tendencies are more threatening. The crisis influenced Hungary's advantages markedly. The high FDI stock means at the same time a high exposure for the Hungarian economy which could be one factor contributing to the uncertainty for investors. According to the figures since 2008 the negative tendencies are significantly more noticeable in Hungary than in the abovementioned countries. In the competitiveness ranking Hungary had a weaker position than previously. In this uncertain situation it is most important to improve Hungary's economic and political stability. We think that it is not in a significantly different position to other Central-Eastern European countries and we could promote our advantages better and more efficiently.

The biggest problem in Hungary is to achieve competitiveness via lower wages. Low wages are the barriers of creating workplaces with higher added value, because the well-trained workforce is rather going to West-European countries. However this is not the most important factor to investors, it results in point of fact the phenomena of brain drain and in the long run reduces the chance to increase productivity, competitiveness as well as economic performance. Hungary has good production resources but just lesser resources when it comes to trained labour. We must create a knowledge-based society, influence the rate of research and development and develop knowledge-networks. These factors could grow our advantages. At the end of our working paper we think so that the FDI stock and the competitiveness is related but not significant.

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