TITLE: The Politics of Economic Transformation: Foreign Investment and the Transition to Open Market Economies in Eastern Europe, a Case Study of Poland and Hungary

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COUNCIL CONTRACT NUMBER: 805-13

DATE: May 5, 1993

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* The work leading to this report was supported by contract funds provided by the National Council for Soviet and East European Research. The analysis and interpretations contained in the report are those of the author.
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THE POLITICS OF ECONOMIC TRANSFORMATION:

Foreign Investment and the Transition to Open Market Economies
in Eastern Europe, a Case Study of Poland and Hungary

ANNE HENDERSON

EXECUTIVE SUMMARY

Foreign investment is clearly critical to the economic reconstruction of Eastern Europe. The capital-poor economies of Eastern Europe are in desperate need of financial resources, and given their heavy debt burdens, foreign investment is the most feasible source of external financing. Furthermore, the technological and managerial resources which foreign investment provides are needed to modernize Eastern Europe’s backward physical plant and managerial practices. Yet although foreign investment is critical for all Eastern European countries, some have been more successful in attracting it than others. For example, since 1989, Hungary has attracted six times more foreign investment per capita than Poland. This startling disparity is due less to differences in foreign investment regulations (which are quite similar in Hungary and Poland) than to the fact that Hungary has formulated a coherent, aggressive, and well-publicized strategy to promote foreign investment, while Poland has been afflicted by near-continuous political and economic disturbances which have impeded the creation of an effective foreign investment program.

Poland’s economic recovery in the past two years has been fueled mainly by the dynamism of the small-scale private sector, and owes relatively little to foreign investment. The barriers to foreign investment can be grouped into three general categories: economic conditions, the political climate, and the bureaucratic environment. In terms of economic conditions, foreign firms have been discouraged by the underdevelopment of Poland’s infrastructure; by the government’s recurrent external debt difficulties; and by the deteriorating condition of most state enterprises, which are unattractive targets for foreign investment. In addition, some foreign firms eschew investment in Poland because the strength of the labor movement undeniably complicates the process of acquiring and running a
business. But other investors may find that it is not difficult to co-opt workers councils and unions through relatively modest concessions. Since labor costs are so low in Poland compared to western Europe, foreign investors can offer wage increases, and can promise no layoffs for a specified time, without deeply affecting firm profitability. Thus, it could be possible for foreign investors to ensure labor compliance fairly cheaply, and a moderately sensitive labor relations policy might prove sufficient to defuse most workplace conflicts.

The four governments which ruled Poland between 1989 and 1992 presided over constant changes in personnel and policy which created a daunting barrier to foreign investment. As one government succeeded another, foreign investors were bombarded by confused and often contradictory policy signals. No Polish government between 1989 and 1992 managed to develop a coherent strategy for attracting foreign investment. Instead, an environment of political instability and inconsistency prevailed.

The failure of Poland's political leadership to devise a coherent foreign investment strategy was compounded by bureaucratic inertia and infighting. In the absence of a clearly defined policy mandate, the Polish agencies charged with implementing foreign investment policies followed their natural instincts to engage in endless turf squabbles, bureaucratic obfuscation, and denial of responsibility.

Another factor impeding the formulation of a coherent foreign investment strategy was the conflictual nature of relations between the government and the Sejm. Opposition parties realized that the weakness of the successive governing coalitions provided an ideal opportunity for attacking the government. Taking advantage of pervasive public cynicism about privatization, parties such as the KPN were able to mount crippling attacks against the government's "sellout" of the Polish patrimony to foreign exploiters.

Between 1990 and 1992, Hungary attracted more than half of the total $7 billion in foreign investment in Eastern Europe. Hungary has been more successful than Poland in attracting foreign investment for several reasons. One important factor was Hungary's extensive experience with market oriented economic reform, dating back to the 1960s. In addition, Hungary's excellent relations with the international financial community give foreign investors a form of confidence which is lacking in Poland's debt-stricken economy. Finally, Hungary's political elite has consistently encouraged foreign investment; its
bureaucracy has adopted a more laissez-faire attitude than in Poland; and its working class has been remarkably quiescent.

Hungary's ruling coalition has simply been more stable and cohesive than Poland's succession of fractious governments. This has allowed the HDF to formulate a more coherent foreign investment strategy, to ensure its more timely bureaucratic implementation, and to protect it more effectively from opposition attacks. Given the consensus within the policymaking elite that foreign investment was critical, it is not surprising that Hungary made more systematic efforts than Poland to minimize the bureaucratic obstacles impeding foreign investment. With top officials in all relevant ministries supporting foreign investment, potential foreign investors were less likely than in Poland to encounter sharply contradictory responses from the various agencies they dealt with.

In addition, the problem of parliamentary opposition to foreign investment was less severe in Hungary than in Poland. The Hungarian governing coalition was cohesive enough to withstand most Parliamentary criticism of its economic policy initiatives. Furthermore, no Hungarian parties took the extreme xenophobic, anti-foreign positions articulated by elements in the Polish system.

The relative assertiveness of social groups affected by foreign investment has clearly created different patterns of group influence over government policy in Poland and Hungary. In Poland, the groups which are positively affected by foreign investment have been politically mute and disorganized, while the groups which perceive a negative impact from foreign investment (particularly unionized state sector workers) have been more vocal and well organized. Therefore, to the extent that social pressures shape foreign investment strategy, the net effect has been to constrain governmental efforts to attract foreign investment. In Hungary, by contrast, the groups which favor foreign investment have been active and assertive. Foreign investors have set up well-organized lobbying associations to influence foreign investment policy. Meanwhile, the groups whose interests are negatively affected by foreign investment have failed to develop either an organizational structure or a coherent policy platform. In particular, labor has exerted a much less powerful influence on foreign investment policy in Hungary than in Poland; Hungarian trade unions have been little
more than passive participants in the privatization process, and no mass strikes like those that crippled several Polish industries have erupted in Hungary.

The inflow of foreign investment has brought indubitable benefits to the Hungarian economy. Yet the latest available figures reveal that the pace of investment is beginning to slow: new foreign investment declined from $1.7 billion in 1991 to $1.5 billion in 1992. The slowdown in foreign investment reveals the fatal flaw in Hungary's privatization strategy. From 1989 till 1992, that strategy relied on preparing a small group of relatively healthy state enterprises for sale to foreign investors. The restructuring of less attractive candidates, and the participation of the Hungarian population in the privatization process, were both more or less ignored. Hungary has now sold off the most attractive chunk of the state sector to foreign buyers, and cannot entice foreign capital to acquire the remainder, which consists mainly of chronic lossmakers. Meanwhile, domestic entrepreneurs and ordinary citizens perceive official privatization programs as the preserve of foreigners, and lack the interest to pick through the leavings of foreign investors. Therefore, the government is left with a sizeable group of state enterprises which have no prospective buyers and few opportunities for restructuring and recovery.

Perversely, the economic condition of remaining state enterprises is actually being undermined by foreign investment. After foreign firms bought the few relatively healthy, desirable firms in each sector of the economy, they proceeded to strengthen their acquisitions with financial and technological inputs. The remaining state firms inexorably lost customers and markets to these foreign competitors. In desperation, many state enterprises turned to asset stripping to maintain wages and employment, thereby making themselves even less saleable. Essentially, foreign capital is driving the majority of the Hungarian state sector into bankruptcy.

Furthermore, the high visibility of large foreign investments in the Hungarian economy is making foreign capital an increasingly obvious target for popular resentment over declining living standards, plummeting real wages, and rising unemployment. Therefore, the challenge for the Hungarian government is to shift the emphasis of the privatization program from attracting foreign capital to mobilizing domestic funds and initiative. In late 1992, the Hungarian government began to take steps in exactly this direction. Motivated by a domestic
political backlash against foreign economic domination and by the slowdown in foreign
capital inflows, it began to study the possibility of distributing shares in state enterprises
through a voucher system—an idea which had previously been taboo. The government also
announced it would privatize more state enterprises through public offerings, and would offer
Hungarian citizens tax preferences and easy payment terms to entice them to buy shares.
Government officials stress that the new strategy of encouraging domestic participation in
privatization will exist alongside continued foreign investment, rather than replacing it. But
it is clear that the era of foreign domination of the Hungarian privatization program has come
to an end, for both political and economic reasons.
The Politics of Economic Transformation: 
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in Eastern Europe, a Case Study of Poland and Hungary

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The choice of privatization strategy is one of the most controversial and complex aspects of the transition to capitalism in Eastern Europe. The debate over privatization has coalesced around two central issues: the pace of ownership transformation, and the methods for ownership transfer. In terms of pace, some argue that the low labor productivity, poor product quality, deteriorating financial condition, technological backwardness, and operational inefficiency of state-owned enterprises make their immediate transfer to private ownership imperative. Others put forward gradualism as the only feasible strategy. In terms of method of ownership transfer, any proposed method for privatization has to contend with several problems characteristic of post-socialist economies. One is the issue of valuation—how to determine the market value of state enterprises and ensure a "fair" sale price. Another problem is the dearth of domestic capital. The only individuals with the economic resources to purchase state enterprises tend to be the former Communist elites, and the idea of handing state property back to its erstwhile exploiters is not a popular one. Yet another problem is that of economic restructuring. It is unclear how privatization of state assets will magically raise the lagging technological level and overcome the managerial idiocies of the socialist period, since private economic actors in Eastern Europe are in possession of neither high technology nor managerial expertise.

To some Eastern European economists and policymakers, foreign investment offers an attractive answer to many of the puzzles of privatization. Foreign investors, armed with sophisticated accounting and valuation tools, could assess the worth of ailing state enterprises. Foreign investors, with their extensive resources and access to international financing, could inject desperately needed capital into the Eastern European economies. Furthermore, foreign investors, with their command of advanced western technology and
know-how, could modernize Eastern Europe's woefully backward physical plant and managerial practices. Finally, foreign investors could provide the access to international marketing channels which the firms of Eastern Europe, long accustomed to circulating third-rate merchandise among themselves, sorely lacked.

Despite its obvious advantages, foreign investment is not universally regarded as the second coming in Eastern Europe. Foreign investment entails the depressing possibility that Eastern European nations would simply exchange external military domination by the Soviet Union for external economic domination by western capitalism. This prospect is not made any more palatable by the memory of certain territorial indignities committed by a former fascist state which is now poised to become the largest investor in Eastern Europe.

This essay explores the politics of foreign investment in Eastern Europe. In the interests of brevity, the following short synopsis will focus on a comparative examination of two countries--Hungary and Poland--whose foreign investment strategies have followed markedly different trajectories. Through analyzing the distribution of power and interests within the Polish and Hungarian states, as well as the relative strength and governmental access of social groups in the two countries, the essay will develop a political explanation for an economic conundrum: since 1989, why has Hungary attracted six times more foreign investment per capita than Poland?

The Politics of Foreign Investment in Poland

Poland's partial economic recovery in the past two years owes relatively little to either foreign investment (which has been limited) or to the government's own privatization policy (which was both poorly designed and imperfectly implemented). Instead, it reflects the autonomous dynamism of a largely small-scale indigenous private sector which is flourishing as much in spite of as because of official government policy.

Several positive developments in the Polish economy are undeniable: industrial production, which fell 39% between 1990 and 1991, grew by 3.5 percent in 1992, and Poland became the only former communist country to record a positive economic growth rate. Progress in privatizing small and medium-size enterprises was dramatic, and by the end of 1992, ninety percent of the retail sector was in private hands.\(^1\) Measured in terms of
employment and output, Poland's private sector is currently the largest in Eastern Europe. On the other hand, progress in privatizing large state firms has been glacially slow. In 1991, a grand total of 11 large enterprises were sold through public offerings, while 18 were auctioned off to foreign and domestic investors—leaving around 8000 state owned firms to dispose of otherwise. Meanwhile, not a single large state enterprise has been shut down; most continue to limp along at greatly reduced levels of output, subsisting off credits from other state firms and cannibalizing their own assets while steadily laying off workers and reducing wages.

One of the main reasons for the slow pace of large-scale privatization has to do with the limited inflow of foreign investment. Foreign firms' concerns about investing in Poland can be grouped into three general categories: economic conditions, the bureaucratic/regulatory environment, and the political climate. In terms of economic conditions, foreign firms have been discouraged by the underdevelopment of Poland's infrastructure; by the government's recurrent difficulties in dealing with its external debt problems; and by the deteriorating condition of most state enterprises. Simply put, most state enterprises are not attractive targets for foreign investment—particularly since their communist-era accounting practices make it extremely difficult for potential western investors to decipher their profitability, track record, or efficiency. Regrettably, the Polish government has done almost nothing to initiate rehabilitation programs in its state enterprises to make them more attractive. Nor has it made rapid progress in setting up the financial, technological, and institutional infrastructure necessary to support foreign investment.

Foreign investors are also disturbed by the government's continuing difficulties in meeting IMF standby performance criteria. Without the IMF "seal of approval," Poland is shut out of debt restructuring, deprived of access to new credits—and placed at a competitive disadvantage for obtaining foreign investment.

Poland's bureaucratic and regulatory environment has created problems for potential foreign investors. The regulatory obstacles do not involve the foreign investment legislation itself, which most western firms regard as clear, logical, and highly competitive with the regulatory conditions prevailing in other Eastern European nations. Instead, the problem lies in the government's failure to enact transparent regulations in areas related to foreign
investment. For example, the lack of full regulatory protection for intellectual property rights inhibits the inflow of technology. Furthermore, with fifty different laws on the books concerning land ownership, foreign investors' rights to own, use, and transfer property are cloudy.⁸

Even more seriously, potential foreign investors interested in buying a share of a state enterprise confront a bureaucratic approval process of depressing complexity. Approvals must be obtained from a multitude of separate bureaucracies, and the procedure is retarded by the severe understaffing of agencies dealing with foreign investment as well as the attitude of the government officials themselves. Bureaucrats working in the government's economic ministries include communist holdovers to whom delay and obfuscation comes naturally; inexperienced new recruits terrified that making rapid decisions will result in massive errors of judgement; and foreign advisors circumscribed by the resentment and suspicion of their Polish colleagues. Finally, the constant personnel shuffles which have characterized Polish government agencies since 1989 have made it impossible for foreign investors to form the kind of stable relationships with government officials which are so necessary to facilitate the investment approval process. Sometimes investment deals painstakingly negotiated with a certain set of government officials are abruptly derailed by a change in personnel, which sends negotiations back to the beginning.⁹

Constant personnel changes in Polish agencies is but one symptom of a larger problem: the political instability which plagued Poland from 1989 to 1992. The four governments which ruled Poland in quick succession between 1989 and 1992 achieved neither internal cohesion nor external credibility, and the constant changes in personnel and policy created a daunting barrier to foreign investment. As one government succeeded another, foreign investors were bombarded by confused and often contradictory policy signals.¹⁰ No Polish government between 1989 and 1992 managed to develop a coherent, clear, and well-publicized strategy for attracting foreign investment. Instead, an environment of political instability and inconsistency prevailed.¹¹

In the four years since the collapse of Communist rule, Poland has been ruled by a succession of unstable governments. After Solidarity candidates won a resounding victory in the June 1989 parliamentary elections, Tadeusz Mazowiecki assembled a Solidarity-led
coalition government. Yet within a year, the fragile unity of the Solidarity organization crumbled into vicious political infighting and profound disagreements over economic strategy. All attempts to deal with the foreign investment question disintegrated into unresolvable conflicts between free market advocates of foreign capital inflows, and nationalist opponents of outside (especially German) economic domination.12

The outcome of the 1991 elections complicated the already difficult task of creating an effective approach to foreign investment. For one thing, the elections revealed profound popular disenchantment with radical reform, which made it harder for the government to maintain a policy course in favor of rapid privatization and foreign investment. Furthermore, the elections dispersed votes among a multiplicity of parties and necessitated the formation of a coalition government. After months of conflictual negotiations, a five party coalition government was finally assembled.13 Yet since the members of the coalition were bound together by little more than a common desire to stay in power, efforts to build a consensus on privatization and foreign investment dissolved into constant infighting.14 The confusion and incoherence of government economic policy was compounded by contradictory statements emanating from different groups in the unstable coalition. Some xenophobic individuals (including the Privatization Minister) called for renegotiating all joint venture contracts on the grounds that the previous government had given away Polish firms to western buyers. Yet at the same time, other coalition parties mounted desperate appeals for foreign capital.15

In June 1992, after five months of political stalemate, the Olszewski government collapsed and talks began to construct a new coalition.16 Eventually, Hanna Suchocka managed to patch together an improbable coalition of the economically liberal Democratic Union party, the right-wing Nationalist Catholics, and the Liberal Democratic Congress party. Though the members of this coalition hold profoundly divergent views on economic policy and the role of foreign capital in Poland’s economy, they have managed to work together by delegating economic policymaking to the liberal reformist parties while allowing the Nationalist Catholic party free rein to pursue its extreme right-wing religious agenda.17

The failure of Poland’s political leadership to devise a coherent foreign investment strategy was compounded by bureaucratic inertia and infighting. In the absence of a clearly
defined policy mandate, the Polish agencies charged with implementing the privatization and foreign investment process followed their natural instincts to engage in endless turf squabbles, bureaucratic obfuscation, and denial of responsibility.

One of the most significant bureaucratic impediments to rational foreign investment strategy is the multitude of agencies involved in approving foreign investment in joint ventures and former state enterprises.\textsuperscript{18} Despite the multitude of agencies and ministries involved in foreign investment, there is no coordinating body capable of bringing together representatives from involved bodies and facilitating joint decision-making. Instead, the bureaucratic actors involved in foreign investment remain isolated from one another, often inadvertently handing down conflicting decisions, and sometimes clashing openly over foreign investment deals.

Coherent foreign investment strategy has been impeded not only by lack of coordination among the multitude of involved bureaucratic agencies, but also by the absence of a perceptible political mandate concerning foreign investment. Theoretically, lack of political guidance could free bureaucratic actors to formulate policy themselves. But in Poland, the political leadership vacuum has not impelled the bureaucracy to take the lead on devising foreign investment strategy. Any action to promote specific foreign investment projects or to propound general investment policy guidelines would be fraught with risks. Opposition parties and the press circle the government like piranhas, alert for news of any investment deal which can be denounced as a shameful sell-out of Polish assets. Few bureaucrats wish to risk the wrath of their political bosses or the contumely of the opposition for the sake of a foreign investment deal. Delaying and foot dragging, by contrast, carry no penalties; bureaucrats are not attacked in the press or parliament for failing to sell an enterprise to foreign investors. Therefore, bureaucrats in all ministries have clear incentives to stall, equivocate, and dodge responsibility for approving foreign investment deals.\textsuperscript{19} 

Another factor impeding the formulation of a coherent foreign investment strategy was the often conflictual nature of relations between the government and the Sejm. On many occasions, Sejm deputies held up the passage of legislation relating to foreign investment.\textsuperscript{20} Opposition parties realized that the weakness of the successive governing coalitions provided an ideal opportunity for attacking and discrediting the government. Taking advantage of
pervasive public cynicism about privatization, parties such as the KPN (Confederation for an Independent Poland) were able to claim that Polish firms were being systematically undervalued by government officials and then sold to western investors for nominal amounts. Successive Polish governments reacted to such populist attacks with considerable trepidation, since they lacked either the firm popular support base or the internal cohesion to withstand sustained political warfare. Often, the government tried to outflank or pre-empt populist rhetoric by adopting it itself. For example, in 1992 government spokesmen proclaimed that Polish firms would never become the victims of "unfair" selloffs to rapacious foreign capitalists. Such statements were intended purely for domestic political consumption, to provide some sort of populist rhetorical substitute for a genuine economic program and to deflect the criticisms of parties such as the KPN. But they had the unintended side effect of scaring off foreign investors, who took the government's floundering efforts to tap into populist nationalism at face value.

It is important to note both the limitations and the undeniable effects of opposition attacks on the government in the Sejm. Opposition parties never presented a coherent alternative to government economic policies or a plan for rehabilitating the Polish economy in the absence of foreign investment. Yet the strident denunciations of opposition deputies nevertheless had an indirect effect on government policy. Government officials hesitated to support foreign investment unambiguously, for fear of catalyzing a right-wing backlash. Essentially, the Polish government's internal weakness and failure to present a comprehensive economic restructuring strategy left it vulnerable to attacks by demagogic opposition parties, and further set back efforts to construct a foreign investment program.

In order to understand the evolution of Poland's foreign investment strategy since 1989, it is important to analyze the activities of the major social groups and actors affected by foreign capital inflows. One such group consists of state sector enterprise managers. For these managers, foreign investment brings both the promise of capital and technology infusions, and the threat of management and worker layoffs. In balancing the relative risks and rewards, a majority of state sector managers apparently favor the possibility of foreign investment in their firms. In an environment in which CMEA markets have collapsed, domestic purchasers have ceased payment, and domestic credit for restructuring is almost
impossible to obtain, many state enterprise managers see foreign firms as the only source of capital inflows and new markets. Yet state enterprise managers have not taken an active and vocal role in pressuring the Ministry of Ownership Transformation to move more quickly on foreign investment deals. One possible reason is the legacy of the spontaneous privatization which took place in 1988-9, when many state enterprise managers took advantage of the collapse of political authority to sell their firms for a pittance in return for bribes. Public and governmental suspicion of state enterprise managers remains high, and this mistrust may well impede managers’ ability to press for rapid finalization of privatization deals.

While enterprise managers’ responses to foreign investment have been muted, workers and unions have not been reticent about airing their reactions to privatization in general and foreign investment in particular. In terms of militancy, unionization, and strike activity, the Polish working class is by far the most politically active in Eastern Europe. But high working class mobilization coincides with extensive working class division. Solidarity has long since splintered into warring factions, and a multitude of competing unions has emerged to challenge the fragments of Solidarity. In addition, shopfloor organizations in the form of workers’ councils and strike committees often crosscut or undermined the power of the national union organizations.

The largest splinter of the Polish union movement, which still calls itself Solidarity, confronts unique constraints and opportunities in its efforts to influence government foreign investment policy. Solidarity’s access to government is much greater than other unions. While this privileged access to government might seem to enhance Solidarity’s political influence, in practice it has served mainly to hobble Solidarity’s freedom of manoeuver and undermine its credibility among workers. Solidarity’s desire to simultaneously represent the interests of its working class constituency and support the government’s economic program has severely strained the unity and effectiveness of the organization. As a result of its inherently contradictory position in Polish politics, Solidarity speaks with a divided and ambiguous voice on many aspects of governmental economic policy, including foreign investment. Since 1989, the Solidarity leadership has referred to foreign investment as an invaluable source of jobs and a stimulant to economic recovery. But at the same time,
Solidarity has opposed layoffs and real wage declines; insisted that privatization focus more on distributing shares in state enterprises to workers; and demanded the strengthening of union rights to participate in enterprise decision-making. These platforms are all incompatible to some degree with unrestricted foreign investment.

Exploiting Solidarity’s division and uncertainty are a growing number of competing unions, including national organizations such as OPZZ and Solidarity-80, as well as hundreds of local and industrial unions. OPZZ and Solidarity-80 have taken an unrelentingly hostile stance towards the government’s economic reform program and foreign investment, although for opposite reasons. OPZZ, the former communist-era trade union, must continually "prove" its radical credentials in order to refute its history of collaborationism, while Solidarity-80 is determined to stay true to the oppositionist philosophy of its origins. Both organizations are profoundly suspicious of the sacrifices which economic reform demands of the Polish working class, and of the ramifications of extensive foreign investment. Yet it is important to note that there has been an inverse relationship between the stridency of union denunciations of government economic policy, and the degree of access to government decision-making forums. Until 1993, the only political weapon of radical unions was the strike, since they were excluded from the policy-making process.

While Solidarity agonized over its contradictory goals and OPZZ issued denunciations which fell on deaf governmental ears, local union organizations and workers councils were having a less public but more concrete impact on foreign investment flows. Any foreign investor seeking to buy into a state enterprise must first obtain the consent of the workers' council. In many instances, workers councils have rejected privatization and foreign investment deals which would lead to layoffs, pay cuts, and revocation of their previous rights to control enterprise investment, wage, and hiring decisions. But in other cases, workers councils have reached accommodations with foreign investors which protect jobs and wages for a specified period of time.

The fragmentation and decentralization which characterize the Polish labor movement make it difficult to reach general conclusions about the impact of labor activism upon the formulation and implementation of foreign investment policy. But in the past two years, a significant shift in union strategies and government-union relations has begun, and this shift
will strongly affect the future of foreign investment. The first sign of change was a vast increase in the scope and intensity of union-supported worker strikes and protests in 1992.\textsuperscript{30} Foreign investment was very much an issue in some of the strike actions. For instance, one of the most bitter and notorious strikes occurred at the FSM Car Plant, which was in the process of being acquired by Fiat. When Fiat announced that its acquisition would coincide with 5000 layoffs and only minimal pay increases, FSM's 23,000 workers went on strike. They demanded that Fiat raise wages to the level prevailing in Italian plants, and renounce all layoffs.\textsuperscript{31}

After the bruising confrontations between the government and striking workers in the summer of 1992, both sides began to explore the possibility of compromise. In late 1992, government and union representatives began to negotiate the terms of an enterprise pact designed to replace confrontation with negotiation as the means of settling industrial policy disputes.\textsuperscript{32} The enterprise pact, which is the first of its kind in Eastern Europe, has the potential to transform relations between workers, owners, and the state. Such a transformation would in turn have major implications for the future of foreign investment in Poland. The enterprise pact incorporates worker rights which some foreign investors might interpret as excessive burdens on managerial prerogatives. For example, workers would be guaranteed a role in enterprise management and veto power over major decisions.\textsuperscript{33} But most foreign investors are well aware that completely untrammelled business environments do not exist anywhere, and would be willing to give up a measure of managerial autonomy in return for guarantees of labor peace. A stable, smoothly functioning mechanism for consultation between labor, business, and government could help alleviate the anxieties of many potential foreign investors concerning labor volatility and intractability in Poland.

Some foreign firms will continue to eschew investment in Poland because the strength of the labor movement undeniably complicates the process of acquiring and running a business. But other investors may find that it is not difficult to co-opt workers councils and unions through relatively modest concessions. Since labor costs are so low in Poland compared to western Europe, foreign investors can offer wage increases, and can promise no layoffs for a specified time, without deeply affecting firm profitability. Thus, it could be
possible for foreign investors to ensure labor compliance fairly cheaply, and a moderately sensitive labor relations policy might prove sufficient to defuse most workplace conflicts.34

Poland is not on the verge of becoming the next hot spot for foreign investment in Eastern Europe. Negative investor perceptions dating back to the 1970s will take time to eliminate, and so will the very real infrastructural and economic problems which have discouraged foreign investment in the past. Nevertheless, the governmental paralysis, bureaucratic foot-dragging, and labor strife which previously affected foreign investment policy show signs of abating. If the current tenuous truce within the ruling coalition and between the government and society deepens into lasting accommodation, Poland may be able to develop the clear, coherent, and effective strategy on foreign investment which has for so long eluded government policymakers.

The Politics of Foreign Investment in Hungary

Hungary's ongoing economic transformation has been similar to Poland's in one fundamental respect: the rise of a dynamic private sector has coincided with profound recession and structural stagnation in the state sector. Yet alongside this similarity is a significant difference. While the dynamism of Poland's private sector has been largely a reflection of domestic entrepreneurial initiative, in Hungary foreign investment accounts for a much greater proportion of private economic activity. In a real sense, foreign investment has been the driving force behind privatization in Hungary.

Between 1990 and 1992, Hungary attracted more than half of the total $7 billion in foreign investment in Eastern Europe. This figure is particularly remarkable in light of the fact that Hungary accounts for less than ten percent of Eastern Europe's population.35 Hungary's success in attracting foreign investment owes much to the longstanding belief of the Hungarian political elite that integration into the world economy is a precondition for domestic economic growth. Foreign investment first began to play a significant role in the Hungarian economy in the 1970s. Between 1972 and 1989, Hungary attracted $570 million in foreign investment. In 1990, an additional $1 billion was invested; in 1991, another $1.7 billion; and in 1992, foreign capital flowed in at a rate of more than $100 million per month.36
The inflow of foreign investment has brought indubitable benefits to the Hungarian economy. These benefits fall into three major categories: improvements in Hungary's external balance; modernization of Hungarian industry; and acceleration of the Hungarian privatization process. Yet the latest available figures reveal that the pace of investment is beginning to slow: new foreign investment declined from $1.7 billion in 1991 to $1.5 billion in 1992. The slowdown in foreign investment reveals the fatal flaw in Hungary's privatization strategy. From 1989 till 1992, that strategy relied on preparing a small group of relatively healthy state enterprises for sale to foreign investors. The restructuring of less attractive candidates, and the participation of the Hungarian population in the privatization process, were both more or less ignored. Hungary has now sold off the most attractive chunk of the state sector to foreign buyers, and cannot entice foreign capital to acquire the remainder, which consists mainly of chronic lossmakers. Meanwhile, domestic entrepreneurs and ordinary citizens perceive official privatization programs as the preserve of foreigners, and lack the interest to pick through the leavings of foreign investors. Therefore, the government is left with a sizeable group of state enterprises which have no prospective buyers and few opportunities for restructuring and recovery.

Perversely, the economic condition of remaining state enterprises is actually being undermined by foreign investment. After foreign firms bought the few relatively healthy, desirable firms in each sector of the economy, they proceeded to strengthen their acquisitions with financial and technological inputs. The remaining state firms inexorably lost customers and markets to these foreign competitors. In desperation, many state enterprises turned to asset stripping to maintain wages and employment, thereby making themselves even less saleable. Essentially, foreign capital is driving the majority of the Hungarian state sector into bankruptcy.

Furthermore, the high visibility of large foreign investments in the Hungarian economy is making foreign capital an increasingly obvious target for popular resentment over declining living standards, plummeting real wages, and rising unemployment. Therefore, the challenge for the Hungarian government is to shift the emphasis of the privatization program from attracting foreign capital to mobilizing domestic funds and initiative. In late 1992, the Hungarian government began to take steps in exactly this direction. Motivated by a domestic
political backlash against foreign economic domination and by the slowdown in foreign
capital inflows, it began to study the possibility of distributing shares in state enterprises
through a voucher system—an idea which had previously been taboo. The government also
announced it would privatize more state enterprises through public offerings, and would offer
Hungarian citizens tax preferences and easy payment terms to entice them to buy shares.
Government officials stress that the new strategy of encouraging domestic participation in
privatization will exist alongside continued foreign investment, rather than replacing it.39
But it is clear that the era of foreign domination of the Hungarian privatization program has
come to an end, for both political and economic reasons.

In the past, Hungary was more successful than Poland in attracting foreign investment
for several reasons. One important factor was Hungary’s long experience with market
oriented economic reform. The New Economic Mechanism (NEM), initiated in 1968,
gradually dismantled central planning and familiarized at least some enterprises with the
concepts of autonomy, profitability, and financial discipline.40 The NEM paved the way
for foreign investment in several ways. First, it encouraged certain Hungarian enterprises to
seek external markets for their goods, and led to the establishment of extensive marketing
networks in Eastern and Western Europe. The NEM also led to substantial increases in
labor productivity in Hungary. Finally, the NEM created incentives for innovation and
research in Hungarian industry. The existence of highly developed yet comparatively
inexpensive research and development facilities has been an additional spur to foreign
investment in Hungarian industry.41

In addition, Hungary’s uninterrupted debt service record and excellent relations with
the international financial community give foreign investors a form of confidence which is
sorely lacking in Poland’s debt-stricken economy.42

While Hungary’s financial infrastructure is certainly underdeveloped compared to
western capitalist countries, the situation is not quite as dire as it is in Poland. Tax reforms
begun under the socialist regime have created a uniform tax code readily comprehensible to
western investors. Banking reform, begun in 1986, has created the most advanced financial
intermediation system in Eastern Europe as well as the first stock market in the region.43
Furthermore, the Hungarian government has initiated specific policies to improve
infrastructure for foreign investors. For instance, the Hungarian Investment Promotion Agency provides grants for joint venture infrastructural investments.44

However, the difference between the investment climate in Hungary and Poland involves attitudes and perceptions more than concrete regulations. Although Hungarian government officials claim that their foreign investment laws are the most liberal in Eastern Europe, they are really quite similar to those in Poland. The formal rules governing foreign investment simply do not provide an explanation for the divergence in foreign investment levels between Hungary and Poland. Causes must be sought in the behavior of the main domestic actors involved in foreign investment decisions. Poland’s political elite has never provided clear pro-investment signals; its bureaucracy has engaged in laborious scrutiny and delay of numerous foreign investment proposals; and its working class has repeatedly protested against the privatization process. By contrast, Hungary’s political elite has clearly and consistently encouraged foreign investment; its bureaucracy has adopted a more laissez-faire attitude; and its working class has been remarkably quiescent. These facts, more than the legal wording of foreign investment decrees, influence the relative flow of capital into the two countries.

Hungary’s ruling coalition has simply been more stable and cohesive than Poland’s succession of fractious governments. This has allowed the HDF to formulate a more coherent foreign investment strategy, to ensure its more timely bureaucratic implementation, and to protect it more effectively from parliamentary and opposition attacks. Unlike in Poland, the regime’s foreign investment policy has not been clouded by contradictory statements and ambiguous pronouncements emanating from government spokesmen. Instead, the members of the Hungarian governing coalition have worked in fairly close tandem to create a consensual approach to foreign investment. This approach stresses transparency in legislation; minimization of bureaucratic interference in joint ventures; and streamlining and coordinating administrative oversight of foreign investment.

The Hungarian coalition government, led by the Democratic Forum, was not initially expected to generate a coherent economic strategy, since it was composed of several factions articulating mutually incompatible political ideologies. The "Christian Democratic" wing championed traditional family values and a paternalistic neo-corporatist state. Meanwhile,
the nationalist wing glorified "authentic" Hungarian culture, articulated veiled threats against any form of outside interference, and suspected capitalism as a foreign invention. Finally, the liberal wing supported "cosmopolitan" pan-European values and called for Hungary's full opening to the world in conjunction with a rapid transition to a market economy.45

Yet after the 1990 elections, the HDF leadership advanced a consistent program in favor of foreign investment, capitalism, and opening to the west. This stance was possible because the more liberal wing of the party, led by Jozsef Antall, managed to subdue the national populists and exclude their more rabid representatives from the cabinet. The result was a cabinet composed of moderates who solidly supported foreign investment.46

Hungarian government leaders saw foreign investment as an important part of a broader effort to transform the Hungarian economy through intensive interactions with the world economy. They realized that attracting foreign capital would require substantial changes in domestic economic institutions and practices. Yet they saw this fact not as an unwelcome indication of external dictation, but rather as a salutary stimulus to domestic reforms. Foreign investors' demands for more developed infrastructure, higher product quality, and better work discipline would supposedly help transform the Hungarian economy and impel it closer to western standards.47 The elite consensus underlying these calculations—that domestic policy must always be subordinate to external constraints—was hardly a new one in Hungarian politics. Democratically elected leaders were simply expressing the latest variant of an old formula. In previous years, Hungary's domestic development had been shaped by the Soviet Union; now it would be determined by the EC. As Prime Minister Antall admitted, "Our national security can only be guaranteed by big countries that have investment here and an interest in seeing that nothing happens to it."48

Given the consensus within the policymaking elite that foreign investment was critical, it is not surprising that Hungary made more systematic efforts than Poland to minimize the bureaucratic obstacles impeding foreign investment. With top officials in all relevant ministries supporting foreign investment, potential foreign investors were less likely than in Poland to encounter sharply contradictory responses from the various agencies they dealt with. In addition, Hungarian policymakers set up several specialized government agencies to provide guidance and support for potential foreign investors.
All this is not meant to imply the complete absence of conflict within the ruling elite over the issue of foreign investment. Government officials clearly perceived the tension between maximizing foreign investment and ensuring that investments complied with state notions of economic benefit and fair purchase price for Hungarian firms. One segment of the elite, composed primarily of technocrats, rejected the need for regulating foreign investment inflows, and ridiculed the very idea that Hungary could suffer from "too much" western penetration. But other voices in the political leadership called for regulating foreign investment in order to prevent abuses and giveaways of state assets which could generate a political backlash against foreign investment.49

The most persistent regulatory conflicts involved the State Property Agency, Hungary's equivalent of the Polish Ministry for Ownership Transformation. The HDF leadership, concerned that the SPA was following an overly laissez faire approach to privatization, attempted to bring the SPA under direct government control in 1990. But these efforts to impose greater governmental control soon confronted the economic reality that the SPA's staff of 150 was incapable of overseeing the privatization of every one of Hungary's 2000 state enterprises. Either the SPA would have to be vastly increased and the privatization process slowed by systematic bureaucratic controls; or the very idea of supervising and guiding privatization would have to be scaled back considerably. The HDF leadership opted for a limited strategy of using the SPA to oversee the privatization of the largest state enterprises, while allowing the majority of smaller firms to initiate their own privatization programs.50

The SPA's approach to foreign investment was one of general encouragement combined with selective intervention. This entailed giving state enterprises and foreign investors broad latitude to construct their own sale agreements, along with selective intervention to prevent abuses and corrupt deals which could discredit the whole privatization process.51 SPA officials estimate that only around ten percent of privatization deals involving foreign investment in state firms entail intensive SPA involvement; the rest are unsupervised except for the final SPA approval or disapproval.

The SPA's strategy stands in sharp contrast to that of the Polish Ministry of Ownership Transformation. Both agencies confronted the problem of inadequate staff and
resources along with unremitting political pressures to ensure "fair" privatization deals. Yet while the Polish Ministry of Ownership Transformation responded through self-protective bureaucratic delays and evasions of responsibility, the SPA acted more boldly in permitting many deals to go through without extensive supervision. The SPA’s decision to lower the regulatory barriers to privatization contributed to the massive inflow of foreign investment which went unmatched in Poland.

In Poland, a further impediment to foreign investment was the continuous conflict between government and opposition parties in Parliament over economic strategy. The problem of parliamentary opposition was less severe in Hungary. For one thing, the governing coalition was strong and cohesive enough to withstand most Parliamentary criticism of its economic policy initiatives. Furthermore, no Hungarian parties took the extreme xenophobic, anti-foreign positions articulated by elements in the Polish system.52

In Hungary, as in Poland, foreign investment strategy reflects not only the priorities of government officials but the pressures and interests of social actors. But in Hungary, the perceived interests and organizational clout of the various groups affected by foreign investment differ significantly from in Poland. Most importantly, organized labor has a much less powerful influence on government policy in Hungary than in Poland, whereas the influence of foreign investors themselves, organized in joint venture associations and other lobbying groups, is greater.

One of the most striking differences between the foreign investment environment in Hungary and Poland concerns the role and power of trade unions. In Hungary, few foreign firms or government officials regard trade unions as a major factor in investment decisions and policy debates. Legally, the SPA or the firm’s management must obtain the consent of enterprise worker councils before finalizing privatization deals. But in practice, worker councils and trade unions have been little more than passive participants in the privatization process.53 The largely passive response of Hungarian workers to the growing penetration of foreign capital has several causes. One is the fragmentation and weakness of the Hungarian Union movement. Most unions are more preoccupied with fighting among themselves for members than with formulating clear positions on privatization and foreign
investment. As a result, united labor activism or a collective union strategy to influence
government economic policy has been nonexistent.

Furthermore, no mass strikes like those that crippled the Polish mining and coal
industry have erupted in Hungary. In Poland, workers rose up to protest the devastating
blow which privatization and foreign investment dealt to the long-established principle of job
security and full employment. In Hungary, by contrast, the promise of job security had long
since been broken by the economic reforms of the 1980s, and workers had already
internalized the threat of unemployment as an inevitable part of the adjustment process.

Significantly, there appears to be no sense of labor solidarity in Hungary. Workers in
joint ventures and foreign firms are largely non-unionized, and they earn higher pay and
better benefits than their counterparts in the state sector. Therefore, these workers lack
either the organizational networks or the incentives to engage in actions--alone or in
conjunction with other workers--against employers. In fact, foreign investors have remarked
favorably on the docility and passivity of their Hungarian workforces.

One of the features of the foreign investment policymaking process in Hungary which
differs significantly from the Polish system is the organized role of foreign investor lobbies.
Several political organizations have been set up in recent years specifically to promote the
interests of joint ventures and foreign investors in the Hungarian economy. These
organizations, with their focused goals and concentrated memberships, have achieved some
success in expanding the rights and eliminating the restrictions on foreign investment in
Hungary.

The relative strength and assertiveness of social groups affected by foreign investment
has clearly created different patterns of group influence over government policy in Poland
and Hungary. In Poland, the groups which are positively affected by foreign investment have
been politically mute and disorganized, while the groups which perceive a negative impact
from foreign investment (particularly unionized state sector workers) have been more vocal
and well organized. Therefore, to the extent that social pressures shape foreign investment
strategy, the net effect has been to constrain governmental efforts to attract foreign
investment. In Hungary, by contrast, the groups which favor foreign investment have been
active and assertive. Foreign investors have successfully established links with the domestic
entrepreneurial community and with the government, and have used their organizational strength to influence foreign investment policy. Meanwhile, the groups whose interests are negatively affected by foreign investment have failed to develop either an organizational structure or a coherent policy platform with which to influence government policy.

Since 1989, Hungary’s economic strategy has placed top priority upon foreign investment as an agent of economic transformation and development. In some senses, the strategy has been remarkably successful. A combination of facilitative state policies and attractive domestic economic conditions has catalyzed a foreign investment inflow considerably larger than in any other East European country. Furthermore, this extensive foreign investment has indubitably contributed a great deal of capital, technology, and managerial expertise to the Hungarian economy.

Yet Hungary’s economic strategy cannot be judged an unqualified success. The policy of selling off the most attractive state enterprises to foreign investors has reached its limits, and the forward momentum of foreign investment seems to be waning. Meanwhile, the government has failed to develop an effective strategy for privatizing the vast majority of state enterprises too inefficient and unproductive to be of interest to foreign investors. Hungary’s foreign investment success story has been a island of progress in an otherwise rather gloomy economic situation, and it is not clear that the dynamism of a relatively small foreign owned economic sector can carry the entire economy forward into a higher stage of development. Foreign investment will almost certainly continue to be an important government policy priority and source of economic growth in Hungary. Yet Hungary’s future economic recovery and restructuring will have to depend to a greater extent than before on mobilizing domestic sources of capital, innovation, entrepreneurship, and technological development.
ENDNOTES


3. Foreign Broadcast Information Service (FBIS), *Daily Report Eastern Europe*, 28 January 1992, page 21. By the end of 1992, the number of state enterprises sold through public share offerings had risen to fourteen, still a far from commanding figure. Interview with World Bank official. But to be fair, it should be noted that 2000 state enterprises have been privatized in Poland, most small retail outlets which arranged their own sale to private investors.


5. Some private firms and international financial organizations are trying to alleviate the information shortfall and interpret the condition of Polish enterprises for potential foreign investors. The Polish-American Enterprise Fund and the Business Industry Information Agency will put together dossiers on firm's financial and banking history. And organizations such as the World Bank, the IMF, the IFC, and the UNIDO have set up projects to improve the quality and availability of Polish economic statistics. Interviews with World Bank, UNIDO, IFC officials; *Financial Times*, May 3 1991.

6. Interview with World Bank official.

7. Interview with IFC official and World Bank official.


10. Interview with IFC official

11. Interviews with officials at American Chamber of Commerce, Polish Development Bank, and IFC.


15. Interview with UNIDO official and Polish Development Bank official.


18. Interview with officials at Ministry of Ownership Transformation.

19. Interview with American commercial attache, with officials of Ministry of Ownership Transformation, with official at Foreign Investment Agency. Also see Nowa Europa January 29-31 1993.


21. It is interesting that the former Communist party did not adopt a similar strategy of denouncing foreign investment, and in fact remained conspicuously silent on this issue. See FBIS Daily Report, 30 January 1990.


23. Interviews with officials at Foreign Investment Agency and Ministry for Ownership Transformation.


40. Interviews with officials at Ministry of Foreign Economic Relations and Hungarian Investment and Trade Promotion Agency.


44. Interview with official at Ministry of Foreign Economic Relations.


50. Interviews with State Property Agency officials; also, Financial Times, July 19 1990.

51. Interviews with officials at State Property Agency.

52. For more on the Hungarian Socialist party platform, see: Nepszabadsag, October 10, 1989. Also, interviews with officials at Financial Research Limited and Corvina.

53. Interviews with officials at National Bank, Hungarian InvestCenter, and Ministry of Foreign Economic Relations.


55. Interviews with officials at Koppint Datorg and Corvina.

56. Interviews with fellow of Hungarian Institute for the World Economy; official at Hungarian Chamber of Commerce; and Hungarian Investment and Trade Promotion Agency.

57. Interview with official of Joint Venture Association, Hungarian Investment and Trade Promotion Agency, Ministry of Foreign Economic Relations.
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