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Transition from central planning to free and liberalised economies provides rich empirical evidence that FDI can be a positive instrument for economic development. The liberalisation of foreign trade and investment regimes combined with privatisation which puts a premium on improvement in corporate governance creates a conducive atmosphere for attracting FDI. While there were some specific factors that cannot be easily replicated elsewhere, the success of both the economies in attracting FDI has broader policy lessons. Both the countries have benefited from the EU factor; the Association Agreements have not only opened EU markets to manufactures but have also compelled Hungary to liberalise its own foreign trade regime. Commitment to liberal reforms has also been a very important factor in attracting FDI. Since the collapse of central planning in Central and Eastern Europe, Hungary and Poland have consistently been among the most advanced reformers in the region. Their privatisation programme has emphasised on improvement in corporate governance. Hungary was the first transition economy to open the strategic sectors to foreigners. This approach has clearly paid off in terms of improved microeconomic efficiency and growth.

The case of a successful Hungarian industrial readjustment demonstrates that FDI is an important vehicle for integration into the present global economy. FDI-led microeconomic restructuring has resulted in the emergence of a highly competitive
industrial sector firmly integrated into the EU markets. FDI firms have been behind the current expansion of exports, having a strong positive impact on growth and not the reverse. This strong positive impact seems to rest upon a solid foundation.

The evidence of the positive impact of FDI firms is indeed overwhelming. It should put to rest fears that FDI only exacerbates inequality and does little to reduce poverty. First, the impressive economic growth performance that Hungary and Poland have experienced since 1994 would have been impossible without FDI-led microeconomic restructuring assisted by macroeconomic stabilisation. Export-led GDP growth of Hungary and Poland since 1993 resulted in these two countries achieving higher-level production output and per capita income. This also explains the success of the Hungarian and Polish economy in comparison to other Central European economies.

Second, FDI led firms have had a positive impact on the balance of payments. Thanks to their export earnings as well as inflows of foreign investment, both Hungary and Poland were able to avoid a possibly grave balance of payments crisis in 1995. Foreign-owned firms have been heavily export-oriented. In addition, Hungary and Poland had saved large volume of foreign exchange through the import-substitution effect of foreign investment in local industries.

Third, contrary to earlier fears, FDI firms have created more employment opportunities, especially in highly skilled labour sector. By 1997, wholly or partially owned firms represented more than half of the total employment in the manufacturing sector both in Hungary and Poland. During the transition, FDI-led firms were responsible for 75 per cent of newly created jobs in both the economies. Foreign firms have also set
higher standards of pay and requirements, which in turn has set a valuable example for
labour and employers throughout the economy.

Fourth, the FDI-driven process of industrial restructuring has produced
internationally competitive industrial capacities and integrated the Hungarian and the
Polish economy into the largest and the fastest growing economies of the world market.
Firms with foreign participation have contributed to a rapid closing of the initial gap (that
is, at the outset of transition to market economy in 1989) between the potential in terms
of its factor endowment and its performance. The resource-intensive and unskilled
labour-intensive products that dominated Hungary and Poland in pre-1989 export regime
were a symptom of the inability of the two economies under central planning to obtain
benefits of human capital. While during the first phase unskilled labour-intensive
products drove the growth, EU destined exports of technology-intensive and human
capital-intensive products recorded the fastest growth in the second phase of economic
restructuring. Shift from natural resource and unskilled labour-intensive products to
technology and human capital-intensive products to EU-oriented exports suggests the
ongoing integration at a higher end of a value-added spectrum. It also suggests that the
firms seem to have developed the capacity to move up the value-added production chain.

Furthermore, trade between both the economies and the EU has become
increasingly like trade among highly industrialised economies. Intra-industry commerce
has grown rapidly. The gap between exports and imports from the EU in terms of factor
intensities has dramatically narrowed. Both baskets have become more alike with a shift
towards technology and human capital-intensive products.
Fifth, rapid growth of exports of parts and components (manufacturing) suggests advanced integration of Hungarian and Polish firms into EU-wide distribution and production networks.

Sixth, there is no evidence that FDI has created an enclave with little or no connection to the domestic economy. This is hardly surprising considering that firms with foreign participation are present in all sectors of the economy.

There are still several impediments arising from flawed business law, missing or confused components in the legal and regulatory domains, operation of the tax administration framework, and deficiencies in infrastructures of both the economies. The first group includes the restriction on the legal form of conducting business activities in the form of limited liability and joint stock companies; and permits for transactions involving purchase of equity in the domestic firm.

The basic problem in the second group of obstacles is that legal institutions that the state sets up in developed nations to support the creation of wealth are yet to be firmly established. Surveys and interviews suggest considerable legal and bureaucratic barriers to private sector development. The legal system is complex and non-transparent; for instance in Poland, 31 normative acts govern the registration of a new business, and 56 acts pertain to employment by a private firm. Frequent changes in the legal system create uncertainty. The famous 1988 Act on Economic Activity which opened new areas to private business before the collapse of central planning was amended 11 times from 1989 to 1994, that is, on an average of every six months. Despite these changes, the core of the legal system remains rooted in the era of central planning. Furthermore, the legal
framework contains loopholes and inconsistencies and leaves much to corporate lawyers and gives extra leverage to the state in its dealings with firms.

The paternalism of state administration towards private firms continues to be a hindrance to conducting businesses. Its manifestations include arbitrary law enforcement, excessive powers enjoyed by the administration and arbitrarily aggressive actions by the tax administration.

In many respects the changed context of planning in both the countries required regular modification by the governments which is quite unlike the classical model encountered in most Soviet-type economies. There is no apparent clash between planning and market forces; the economy is increasingly open to foreign trade (with market economies) and new forms of co-operation between enterprises are emerging. Individual initiative is encouraged, agricultural productivity is rising, and enterprises in the social sector are increasingly free to make their own decisions. At the same time, the function of macro-economic planning is merely to set guidelines, and a new decentralised financial system has, in principle, replaced the old system of financing activities by means of the State budget.

It is true that the international economic climate is currently not very favourable and that adjusting the internal mechanisms of COMECON might, in the medium term, threaten the smooth running of decentralised economies. Nevertheless, Hungary and Poland’s economic performance after the stringent policy of adjustment adopted during the critical period of the 1980s has outpaced the other COMECON partners.
Despite problems and partial achievements, the leadership of the two countries are determined to pursue reforms and also plans to introduce new measures to increase decentralisation. What is being attempted now is to give a more precise shape to the new model of market socialism.