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**AN FDI-BASED DEVELOPMENT MODEL
FOR HUNGARY – NEW CHALLENGES?**



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SUMMARY

Hungary has taken an FDI-oriented development path during its transition process. The economy has become highly internationalized and largely controlled by foreign-owned firms, which have contributed much by modernizing production, reorienting markets and transferring expertise. However, the initial surge of development seems to be ending, at least in the form it took in the 1990s. Signs of saturation are visible, and the question now is how to open a new chapter of FDI-oriented development. Investment and operation will have to shift towards more sophisticated activities. To effect such changes, Hungary must offer enough qualified labour and an adequate infrastructure. Moreover the investment incentive system needs overhauling, as entry into the EU will outdate otherwise efficient incentives. Efforts must go into organizing the economy according to the National Development Plan, as a backbone for the EU assistance available.

INTRODUCTION

Hungary was long seen as one of the most successful transition economies in Central Europe. The process was rapid and relatively straightforward. The institutions of a market economy were erected. Although many economic structures from the command economy had to be jettisoned, the destruction of capacity and jobs was largely offset by impressive development of new business structures. New Hungarian-owned small and medium-sized firms appeared in labour-intensive industries, while deep restructuring of manufacturing was carried out mainly via foreign direct investment (FDI). Indeed, FDI was decisive in restructuring the economy and modernizing manufacturing.

The very high level of FDI penetration in practically all important branches of manufacturing occurred because the country and its economy were highly attractive and because of a series of successful capital-attraction policies. Hungary had an advantageous location in Central Europe, sufficiently developed infrastructure, and cheap, well-educated labour.¹ Privatization policy was aimed at quick cash sales of state-owned firms, mainly to foreign investors. Other encouragements to investment were a quite generous system of tax holidays and the

option of establishing industrial free-trade zones.² These were coupled with contributions from local government authorities, which produced very favourable investment conditions in many locations. The stock of greenfield investment also started to grow for the same reasons, although this type of development was very much concentrated geographically: Buda-pest received most of the investment and sizeable amounts went to 4–5 other major industrial centres in the North-East, but the remaining three quarters of Hungary received very little.

The turn of the century brought important changes in investment trends. The inflow of FDI started to slow and transfers of profits abroad began. Hungarian-based companies started to go in for FDI, mainly in other transition economies in the region. These three factors reduced the net positive FDI balance, and in the first quarter of 2003, it became negative for the first time since the change of system. The years 2001 and 2002 were ones of general, worldwide decline in FDI, following the terrorist attacks of September 11. Although the 2002 decline in inward FDI was less dramatic in the transition economies than elsewhere, the Hungarian figures show a number of important changes in the composition of the FDI flows. These are apparent in *Table 1*:

¹ See the frequently used motivation categories developed by John Dunning.

² The incentive system of the 1990s is described by Antalóczy and Sass (2003) and Éltesó (1998)

Table 1
Inward and outward flows of FDI in Hungary
in 1995–2002

	1995	1996	1997	1998	1999	2000	2001	2002
Inward FDI balance (€ million)	3474	1815	1922	1815	1849	1835	2715	1073
Share of privatization in inward FDI (per cent)	75.7	31.2	69.6	25.1	17.9	0.0	0.0	0.0
Outward FDI balance (€ million)	33	-2	389	428	237	603	368	272

Source: National Bank of Hungary (NBH) and State Asset Holding PLC.

Inward FDI started to fall in the late 1990s, and a revival in 2001 was due to intra-company loans rather than investment proper, but the stock of FDI continued to increase, as most firms were still reinvesting most of their profits. There was a change in the composition of the increment in the FDI stock: net new capital inflow was declining, while loans and reinvested profits took the lead.³ Also, the sectoral composition changed, with services and trade taking over the first place from manufacturing. Manufacturing investments' hesitation to launch new projects in Hungary was very much evident, when Hungary did not receive any of the new investments in car industry in recent years.

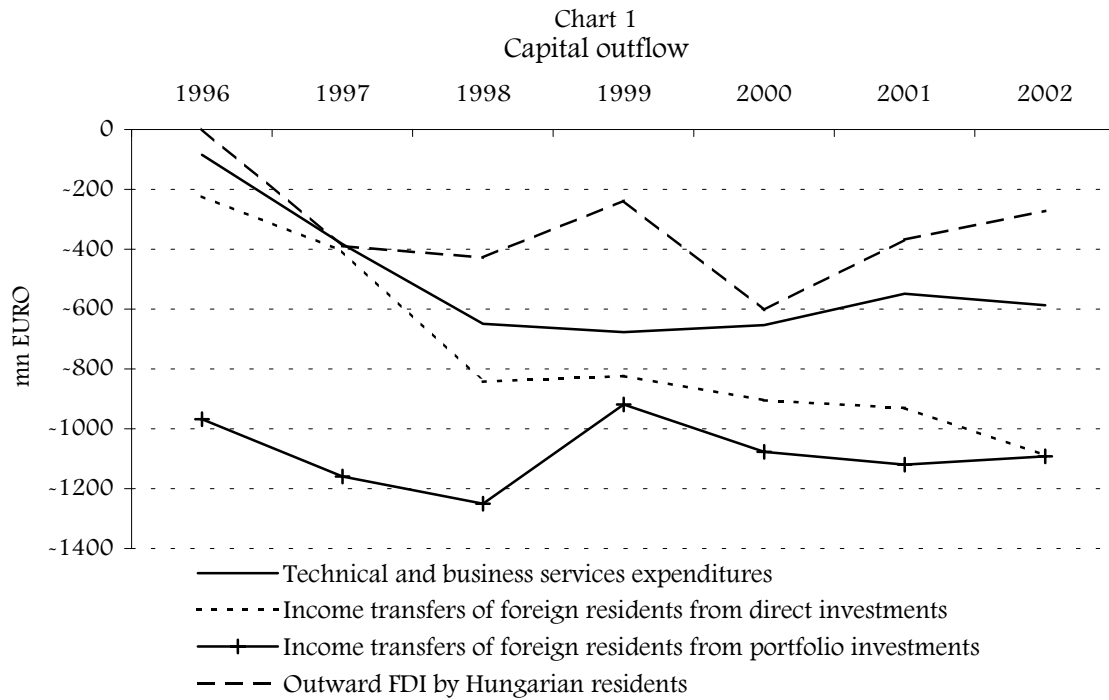
With outflows of capital, a major, but not dramatically increasing proportion of profits were being withdrawn and turnover in royalties and fees increased,

as were loans. These cost items and loan repayments started to play an important role in the balance of payments. Both may cover financial transactions rather than normal commercial deals. The increasing transfers and profit repatriation became, from time to time, major contributors to the deficit on the capital account, although the increase in them also confirms that Hungarian affiliates have been profitable and therefore successful.

Chart 1 shows that various channels of investment-related capital outflow played an important role in the later 1990s and early 2000s. Repatriation of profits on portfolio investments was substantial throughout the 1990s and even earlier. Open profit transfers on FDI jumped in 1998 and continued to grow more slowly thereafter, while net outflow of payments on technical and business services stabilized at some €600 million a year.⁴ Outward FDI fluctuated. The jump in 2000 was due to a major privatization-

³ Unfortunately, the picture is further distorted by a shortcoming in the statistical system. The data is for net inflow and net outflow of FDI, so that it contains the cumulative impact of investment and disinvestment by non-resident owners of capital. The quite low figure for 2002 therefore reflects a significantly higher level of FDI inflow and a capital outflow of several hundred million Euros, due to closures in some labour-intensive activities.

⁴ The net outflow of technical payments is taken here as a rough measure of hidden profit transfers. The € 600 million negative balance is the result of inward flows in the range of € 2000 million and of outward flows exceeding them.



Source: NBH

related deal in Slovakia that incorporated the Hungarian affiliate of a large multinational company.

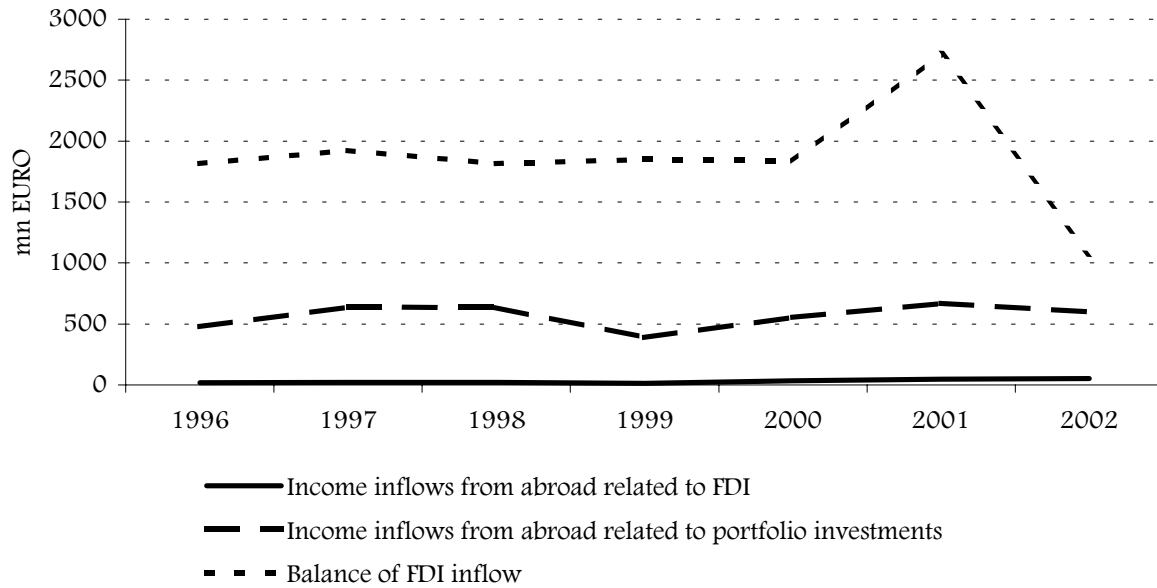
Analysis of the current account is important for two reasons. (i) Changing investment and income flows bring a restructuring that requires parallel changes in other items in the account. (ii) A big expectation of FDI in the 1990s no longer applies: net FDI inflows no longer help to stabilize the current account. On the contrary, the reduction of nominal FDI inflow and increasing outflow of incomes and payments of FDI-related fees may take the capital and income flows into negative territory, as happened in the first quarter of 2003.⁵ As for the strong outward flow in technical and business fees,

here hidden profit transfers are thought to have been a factor, but the level and intensity depended mainly on the needs of global company networks. Transfer pricing is widespread but the reasons for it vary. Hidden profit repatriation used to be the main suspect, but this can hardly apply in Hungary. The main foreign firms received tax holidays that gave them an incentive to channel profits into, not out of the country. Such inward transfers were often seen when Hungarian affiliates of multinationals reported unexpectedly high rates of profit. Nonetheless, the brackets of business services' costs and repaid loans were continually high, which indicates a different rationale behind these transactions.

Coming back to the issue of restructuring in the current account and the changing role of FDI, the prime comparison should be between inward and outward flows. *Chart 2* shows income flows from abroad and net inward FDI

⁵ Great caution is called for in combining figures from different parts of the current account. Profit and payment flows belong to the current account and capital flows to the financial account. Despite their different natures, they can be compared from the somewhat mercantile angle of national liquidity.

Chart 2
Capital inflow



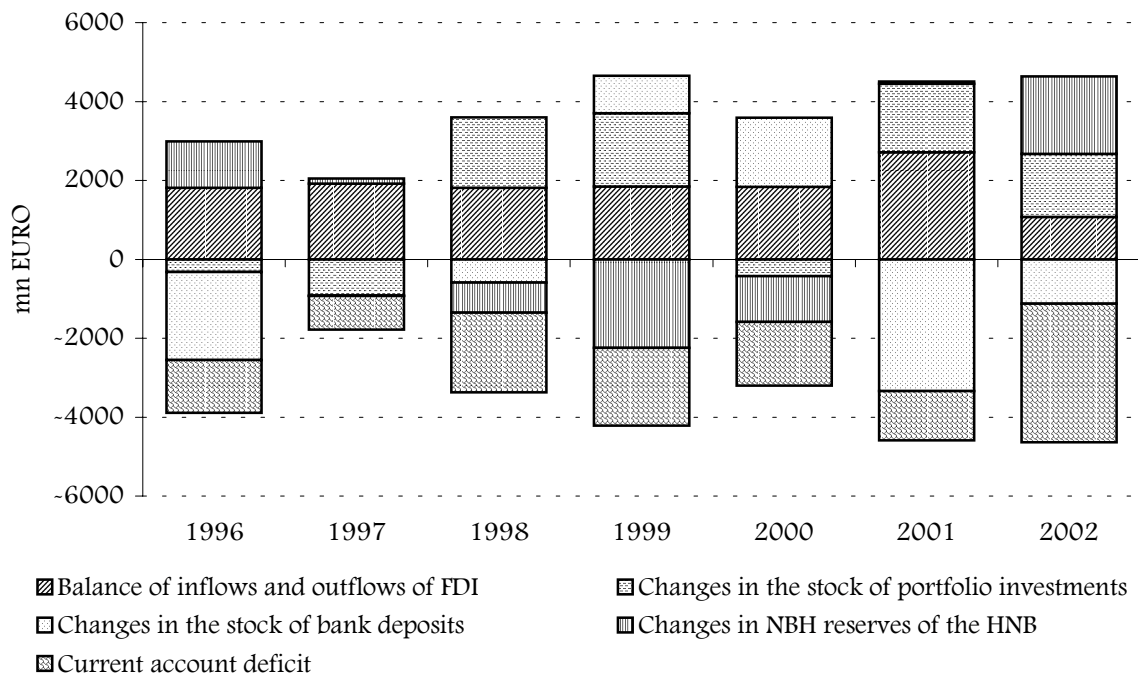
Source: NBH.

levels. A comparison of this chart with the previous one shows that both income levels are significantly lower in the inward direction. Thus the net result of both inward and outward income flows is negative. With portfolio-related incomes, the net outflow is larger, but up to the end of the 1990s, the net inflow of FDI (the net balance of inward and outward flows) showed a significant surplus, which more than covered the net income outflows. According to some theories of the 'natural path' of FDI, the balancing role will be taken over in time by the increasing inward income flows. The current FDI stock held by Hungarian residents abroad does not allow high levels of income transfers, so that it will be some time before the income inflows start to perform such a function. The question remains how the income gap can be closed if net FDI inflow does not help.

Chart 3 relates the current account to some important potential sources of financing (changes in stocks of deposits and portfolio, NBH reserves, net FDI inflow).

The columns in *Chart 3* primarily show that the negative and positive slopes were roughly equal in each year. This means that overall, the items investigated offset each other and the slight surplus is obviously due to factors not included here. However, there are important shifts in the structure, above all an alarming increase in the deficit on the current account, caused primarily by a huge increase in the trade balance. Income flows did not change very dramatically. It is also clear that the net inflow of FDI lost momentum: consider the 1995 figure in Table 1 or the entire 1992–6 period. The third important observation is that both the portfolio held by foreign residents (mainly Hungarian state securities), and

Chart 3
Deficit financing source



Source: NBH.

the level of deposits show no clear tendencies over time. They changed very sensitively, sometimes in the same direction, but mainly in opposite directions, seemingly dependent on monetary policy measures and changes on world financial markets. The real balancing role was played by the change in reserves, which is in fact its main purpose.

However, assuming a high current account deficit in the long run and changes in deposits and portfolio stock not completely controlled by national policies, the absence of a massive net inflow of FDI means that the balancing role will have to be taken over by central bank reserves. The conclusions are clear: reserves have to be kept at adequate levels and an upswing of net FDI inflow has to be achieved. This paper looks at the latter option. It is an important task also because the previous high level of FDI in the

various branches of the Hungarian economy made FDI the prime source of future development.

The changing patterns of capital flows need some more analysis. Behind them there are various possible determinants that also bear important policy relevance. These can be interpreted also as the end of a first phase of investment in Hungary, to be followed by one based on different properties and so requiring redefinition of important elements of economic policy, including investment promotion. The first chapter of the paper, identifies the most important features of capital attraction in Hungary in the 1990s and sees how they changed and lost importance by the end of the decade. The second chapter provides a more thorough analysis of FDI-related capital flows, and the third deals with some long-term changes in the country's capi-

tal-attracting potential. The paper ends with some policy conclusions.

1) CHANGING CAPITAL~ ATTRACTING FACTORS

The introductory description of the changing structure of FDI inflows and stock in Hungary indicates that there must have been a shift in the country's attraction potential. The reserves of once-successful attractive factors were exhausted. Investors' interest turned to other investment targets. Under the conditions that pertained, the capital-absorption capacity of the country may also have become saturated. The decline on both the demand and supply sides is interpreted here as an end of a period of capital attraction. To revive the capital inflows will require the establishment and strengthening of new attraction features. There are several arguments to support this diagnosis.

Privatization is over. Up to the late 1990s, privatization in Hungary and other transition economies such as the Czech Republic, Poland and Slovakia provided investors interested in penetrating markets or utilizing cheap labour with a cheap way of expanding capacity. The fluctuation of privatization revenues in the four countries shows a close similarity to the fluctuations in their FDI inflows. This indicates that privatization was the main driving force behind the FDI. The privatization supply is also running out in

the other three countries mentioned, especially in manufacturing. Privatization, as a main episode in the transition to market economic structures, is over now.

Both market-seeking and efficiency-seeking investors were able to find plenty of opportunities to invest in Central Europe in the last ten years. This they did, and they are now present on these markets to a sufficient extent. The investment market in Hungary is saturated. New investors cannot ceaselessly appear. Indeed, the worldwide process of concentration on various markets may decimate the number of market players and limit the number of potential investors. Further expansion and investment can therefore be expected mainly from investors already present on Central European markets. An increasing role will be played by mergers and acquisitions. A number of major acquisitions have already occurred among private firms in Hungary. (These should be distinguished from privatization deals, although they too are acquisitions in a sense.) Mergers and acquisitions were the big driving force behind a sudden worldwide expansion of FDI in the second half of the 1990s, and they dropped back most after the great setback to global FDI flows in 2002. Compared with the decrease in global FDI flows of two-thirds, the current stagnation of FDI in the transition economies is a fairly good performance.

Market saturation has been coupled with rising labour costs. Real wages increased more slowly than productivity in Hungary in 1992–8, and in some years

even declined, so that unit labour costs decreased. In 1998–2000, pay levels more or less stagnated, but in 2000–2002, several government measures were taken to increase pay and the minimum wage. The result was an increase in real wages of about 30 per cent, coupled with a productivity increase of only 10 per cent. Unit labour costs therefore increased. Meanwhile other, rival transition economies posted declines in unit labour costs over the same period. Hungarian wage costs may therefore have risen by as much as 40 per cent compared with neighbouring countries, especially if the effect of continual currency appreciation is added in. The negative effects of this development affected labour-intensive industries and tourism the most, but capital-intensive, efficiency-seeking investments intended to exploit cheap unskilled labour were also hit. Their margins disappeared as well. Increasing unit labour costs decayed the overall competitive position of the country, not just in labour-intensive activities.

A fourth, very effective attraction factor in Hungary consisted of fiscal and regulatory incentives. Long tax holidays for corporate income tax were important tools because they effectively turned Hungary into a tax haven of global value. The profits of global activity can be channelled to low tax locations, which was especially important in Hungary, where investors planned to carry out further investment and invest profits generated elsewhere. Another important tool of this kind was the establishment of industrial free-trade zones, providing customs and

tax exemption not only for operational purchases, but for fixed assets and investments, so that they provided an important long-term cost benefit. Both these inducements were heavily criticized by the EU in the accession negotiations. They were then withdrawn, and no other powerful incentive mechanism has yet taken their place. An effective, EU-compatible system of incentives is still lacking.

These changes in the main tools and conditions for attracting capital have produced a new investment environment in Hungary, reflected in the current decline in new investment. The reserves of the previously effective attraction tools have been exhausted. The inflow of FDI will rise again if the Hungarian economy can provide the conditions for more sophisticated economic activities. The creation of these needs to be the primary goal of future economic policy.

2) CAPITAL FLOWS CONNECTED WITH FDI

Much of the social cost of transition was born by the central budget, which ran a substantial primary deficit until the last third of the 1990s. This was financed partly from privatization revenues and so from FDI. FDI also helped to improve the balance of payments. The situation has changed (i) because the acute budget deficit problems were overcome (although they re-emerged in 2002–3), and (ii) because the net FDI inflow has dried

up. Even if budgetary costs fall, the balance-of-payments aspect remains important, all the more because various capital and income flows have gained importance in the past few years. There are three major flows to discuss: profit repatriation, cost and loan transfers, and outward FDI.

Owners of capital have an unlimited right of free disposal of their taxed profits. This is a basic rule of property rights in a market economy, and applies equally to domestic and foreign owners of capital. Equal treatment is another important market economic principle, which should apply also to the right of profit disposal. Thus to restrict transfers of earnings by foreign owners of capital is a violation of basic market economic principles. Such actions, like nationalization, act as a deterrent to future investment. It is important, of course, to promote reinvestment of profits in Hungary and the current tax system does so quite efficiently. Up to now, major repatriation of profits has occurred only when investors (institutional in the main) wanted to plug losses elsewhere in their global portfolio. The process is rather diverse, for the Hungarian tax regulations attract some profits from abroad. Nevertheless, it is clear that substantial amounts of profit have been transferred from Hungary abroad since the late 1990s. This can be interpreted mainly as positive: earlier investments have performed well and generate good earnings.

Another oft-cited sin committed by multinationals is to use transfer pricing

and other tools to disguise and transfer profits. Inter-company loans and inter-company business services and royalties are usually based on actual performance. However, the price is set administratively, and in many cases, there is insufficient control over this or no suitable market price to compare it with, so that the prices paid are set arbitrarily, to suit the purposes of capital needs or income transfers. It can be inconvenient that local governments have no proper overview of economic events, capital flows or corporate behaviour in companies behaving in this way. Economic policy-making becomes blunter if the reactions of firms to measures cannot be accurately foreseen. Such increasing unpredictability is a feature of globalization, along with the mobility of firms and business. The author believes there is a very wide range of business rationales behind the hidden business transactions carried out through uncontrolled cost and loan schemes, and profit repatriation to avoid taxes is only one of them. Much more important, it seems, is speculation. Certainly speculative capital flows are sometimes several orders of magnitude greater than profit transfers, which makes them dangerous. Such speculative tricks are less likely with FDI, as fixed assets are by definition much less flexible and convertible. Hungary is a good example of false suspicions that profit transfers may lie behind cost and loan transactions. There have been significant fluctuation in these transfers over the last five years, despite of relative stability of the tax regime and exchange rate, and of the Hungarian economy as a

whole. The rationale behind capital movements is provided by the financial requirements of the global corporate network.

Outward FDI from Hungary also has a negative effect on the balance of payments, although it is usually treated as a positive feature of the economy. International expansion by Hungarian-based firms is very much in line with all major policy concepts and necessary from the commercial point of view. There is some discussion among analysts about the real origins of the Hungarian ‘multinationals’. Are major investors like the oil company MOL, the telecom company MATÁV or the savings bank OTP Hungarian firms or just affiliates of other multinationals? The fact of the matter is that there is foreign ownership in all three firms. There are also a few Hungarian manufacturers with affiliates abroad. The question is important in several ways. One is economic policy: analysts suggest that ‘true Hungarian’ firms are more likely to respond positively to policies than other firms. Another aspect is the origin of the capital invested abroad. If Hungarian firms invest, they are likely to be using money mainly raised in Hungary, although this is not necessarily so. Foreign affiliates, on the other hand, are likely to be using funds originating with the parent company, so that they are not withdrawing funds from local Hungarian investment. On the other hand, even if Hungarian money is being invested abroad, international expansion and the process of becoming multinational are important and inevitable constituents of a successful

competitive strategy. Companies must grow in size to match the challenges of bigger firms, or face being crowded out even from their domestic markets.

3) FIRM CLOSURES AND FAILED INVESTMENT PROJECTS

Changes in actual capital flows in Hungary show there has been a change in the investment environment. There have been several cases of closures and failed investment projects, which also deliver useful information on what has changed in Hungary. The most important closures/withdrawals in the past year have been IBM, Flextronics and Marc Shoe, all of which moved to China. Two Hungarian failures to attract investment from the automotive sector occurred: VW preferred East Germany and Peugeot Slovakia. Careful analysis of these highlights the main reasons for the problems and their size and nature. The three factors discussed are shifts in location advantages, insufficient supply of crucial production inputs, and a deteriorating country image.

There has been a trend recently towards closing down facilities in the Hungarian electronics, textile and apparel industries. Mexico had similar experiences last year, as firms moved from Mexico to China, just as they have from Hungary. The divested activities were based on temporary use of cheap unskilled labour: the utilization and duration of the in-

vestment depended on actual world market conditions in this single production factor. This is a particular type of efficiency-seeking investment. There is no sign of other types of investment leaving Hungary or Mexico in large quantities.

The trigger in Hungary was the steady increase in unit labour costs already described, coupled with the emergence of China as a new low-cost investment location. The moves should not be regarded as a failure on either side. The investors were not intending to stay long anyway, as is clear from their failure to put down local supplier roots. Their activity in Hungary was brief but mutually beneficial. Hungary gained employment for several thousand unskilled workers, which was a big relief in a time of high unemployment, and the extra budget revenue from firms that were net taxpayers, despite the tax concessions they enjoyed. It was not really a failure for Hungarian government that these investors did not integrate into the local economy or remain in Hungary in the long term, as those moves were not in the original investment scenario. Indeed, they would have conflicted with it, by decreasing flexibility through accumulation of sunk costs. To some extent, there was spillover for Hungary, as employees learnt from the experience. The move was also predictable from the angle of the host economy. The end of the transition period and approach of EU membership both presaged an increase in real wages that would be bad news for labour-intensive activities. The shift of location was speeded by the opening of large low-cost countries in

Asia. In some ways, the trend can be regarded as a first step in upgrading Hungary's FDI capacities, with an increase in the stock of investments employing skilled labour as the next step. On the other hand, Hungary still possesses substantial reserves of unskilled labour whose employment or training remains a difficult task.

It was also a shock for Hungary to see the shrinking volume of investment in Central Europe preferring locations other than Hungary. In fact, Hungary has not attracted any large new investment projects in the last five years. Even greenfield investment unrelated to privatization has occurred elsewhere in the region. The absence of long-term investment in this period cannot be explained by changes in short-term conditions; cost structure or exchange-rate problems are insufficient to account for it. There has also been a weakening of the country's long-term competitiveness in attracting capital. One factor has been that the supply of qualified labour in the country's main FDI locations has diminished. It cannot be a long-term solution to import such labour from Slovakia, for it would be better employed at home. Peugeot, for instance, has already made the necessary investments there. The proposed ways of overcoming this bottleneck have failed. Migration within the country has not increased. Training schemes for the unskilled have not brought quick results, and the development of infrastructure (especially motorways) has been very slow and failed to provide links between remaining

pools of labour and Hungary's FDI heartland.

There have also been disappointing experiences due to the lack of competitive local suppliers. A strong domestic production background, with sizeable and experienced firms ready to cooperate with incoming investors, is a valuable national asset. For various reasons, this middle swath of Hungarian firms disappeared during the transition process. Local business is still weak and inexperienced, and its technical capabilities often fail to meet the needs of up-to-date, large-scale production. Its financial position is usually weak as well. These deficiencies in local firms increase the risks for multinationals, making it a troublesome and slow process to develop local linkages, even in cases where local-content rules, for example, are impelling foreign investors to increase them. One factor in Peugeot's decision to invest in Slovakia was the existence of appropriate supplier networks in its automotive sector, which had gained experience with VW.

A third problem is that Hungary's image has deteriorated. This was favourable in the 1990s, when Hungary was seen as a pioneer of the transition process in Central Europe. But that image was linked with the change of system, and once the change was over, there remained little to keep the country in the centre of international interest. Other countries were able to link their image with major products or services, 'lead products' with a worldwide reputation.

Hungary had no such lead products. On the contrary, the economic structure moved strongly towards component production. The country image lost focus also because government paid little attention to keeping competitors at bay, concentrating only on attracting new investment. Many of the problems mentioned did not ease over time. They affected existing investors, whose dissatisfaction sent discouraging signals to other, potential investors. This inherent policy problem coincided with anti-FDI rhetoric during the last election campaign, which many investors found disturbing. They were also disheartened by the protracted debate with the EU over retrospective withdrawal of tax concessions, which eroded Hungary's image as a firm supporter of international investment. Thus the deterioration in the ability to attract FDI has been affected by both long and shorter-term changes in Hungary's image.

4) POLICY CONCLUSIONS

Hungary chose a new path of development in the 1990s, hallmarked by the predominant role given to FDI. The first period of this FDI-based modernization model has finished. Hungary has become integrated into the international division of labour at a level corresponding to its available technical infrastructural and human capabilities. The country's reserves have not been utilized fully in some respects. For example, engineering

skills and experiences are still available, and the uneven regional spread of investment has left some production inputs of similar quality unexploited in many parts of the country. However, saturation of the country's ability to absorb FDI and growing competition from neighbouring countries and other regions, along with the global decline in FDI, mean that radical improvements in its current extent and pattern cannot be expected. The challenge is to open up new opportunities and create the basis for a new, higher level of integration into the international system of labour division.

This new status calls for important policy changes, which need to be the basis of the national development plan. Unfortunately, the current national development plan still focuses on matters concerned with the current model and lacks a vision of the country's future. An increase of Hungary's role in the international division of labour calls above all for a regular pool of healthy, well-educated labour. The education and health systems need reorganization. Their performance has deteriorated throughout the transition period, due to almost total neglect, causing a sharp fall in the quality and quantity of accessible labour. The new stage of development requires skilled labour that is flexible, creative, properly trained in informatics, and experienced in other sciences, whereas the education system today produces clerical and manual workers who are theoretically oriented and have highly specialized (inflexible) skills. Knowledge of foreign lan-

guages is still a problem, although there has been some improvement.

The tragic situation in the public health services makes it hard to achieve even simple reproduction of health standards in the labour force. The deterioration (e.g. exceptionally high mortality rates among adult males) also results from tough employment conditions. One of the casualties of the political turmoil in Hungary was the trade-union movement, which leaves employees with no way of effectively protecting their rights, in the face of overall deterioration in conditions and continual overloading by foreign and domestic workplaces alike. In fact, weak unions have been among the capital-attracting factors. Similar trends can be seen in many other countries, but they place considerable strain on health. Stabilizing this situation is an important task of future development.

It is also important to create national lead products. Some attempts have been made in this direction, but they fail primarily for lack of financial support. Campaigns to publicize Hungarian food products have been run in many countries with limited success: the food sector in general has been at a big disadvantage due to massive subsidization of EU products. This may change with Hungary's membership, although there is still jealous protection: for seven more years, there will be no equal treatment of current and new members over agriculture and foods. Still, in terms of its national endowments, Hungary is poised to be an important and efficient EU food producer.

Another area of national strength that could provide a core for future development is informatics. This used to be a rather successful field of science and business in Hungary, and unusually, was successfully promoted by successive governments. Still in the 1980s, an important programme was launched to supply even elementary schools with personal computers, and later with access to the Internet. So there are already traditions of informatics education in the country, which have brought advances in information sciences and in business applications. Informatics and especially software development, could therefore be a focus for future development. The fairly strong position of informatics also provides a promising starting point for a future-oriented overhaul of the education system itself.

There are a number of problems that call for quick government action. The capacity of the country to attract capital needs to be restored, with innovative incentives to replace the ones that had to be lifted. Hungary has always aspired to be a fair and reliable partner that does not seek to run counter to the letter and spirit of agreements. It will therefore be difficult to find opportunities for providing extra gains for investors, especially financial ones. On the other hand, practice in Ireland, for example, shows that the EU would tolerate the use of non-compatible attraction methods for a while, and when these were lifted, new ones were ready for introduction. A similarly flexible, innovative incentive structure could still bestow important ad-

vantages on Hungary in various respects. Unfortunately, there is no sign of such innovation being attempted yet.

Stronger support of domestic entrepreneurs will be necessary, to improve the spread of spillover effects from FDI. Local firms have to grow and develop to a size, technical prowess and financial strength that gives them a chance of developing regular business relations with multinationals. The spread of spillover effects should also be enhanced regionally. An important means of limiting regional disparities is to develop the infrastructure. Highway construction, for instance, has proved a big attractant, and makes countrywide pools of highly educated labour available to new investors.

These ambitious policy proposals would all require investment on a scale that Hungary alone could hardly pay for. The pace of modernization depends crucially on two factors. The first is national capital accumulation. This function has also been weak in recent years, as postponed consumption soaked up earnings, even in the case of entrepreneurs. Even now, the decision-making range of Hungarian entrepreneur is no longer than two or three years, due partly to the continuing high level of uncertainty. This may improve as uncertainty declines. Another potential source of investment is EU funding. The EU has been rather niggardly over funding modernization in acceding countries. The entry of Spain, Portugal, Greece and Ireland was supported by financial transfers larger by an order of magnitude than those being of-

ferred to the transition economies. Nevertheless, a little is more than nothing, and once members, newcomers may be better able to bargain for stronger positions in the next EU budget period, which is due to start in 2007. In that case, EU transfers may provide the backbone for the national development project envisaged here.

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