THE ROLE OF FOREIGN DIRECT INVESTMENT

IN SMALL OPEN ECONOMIES:

COMPARISON OF HUNGARY AND CROATIA

By

Ela Genc

Submitted to Central European University

Department of Political Science

In partial fulfillment of the requirements for the degree of Master of Arts

Supervisor: Professor László Csaba

Budapest, Hungary

2014

Abstract

Foreign direct investment (FDI) has been one of the major drivers of export growth in many countries. Transition countries have proven to be 'best cases', especially the Visegrád group (Poland, the Czech Republic, Slovakia and Hungary). In respect of attracting FDI, Hungary has been considered one of the first and most successful countries of the Central Eastern European region. Like Hungary, Croatia is a post-communist country and a small, open, economy. However, economy-wise, and especially regarding FDI, it has been lagging behind other transition countries in Europe. This thesis aims to abstract the most important elements for creating an FDI-conducive environment in a post-transition economy. I am using an in-depth comparative case study of Hungary and Croatia, in order to deduce FDI-conducive policy recommendations for Croatia. The thesis finds the following elements are necessary and/or need to be reformed: regulated judiciary and effective bureaucracy, flexible labour code, effective local and regional self-administration, investment stimulation and predictable economic policies with an emphasis on taxation policies. The thesis analyzes the aforementioned issues and illustrates areas in which Hungary stands significantly better than Croatia. Furthermore, based on the analysis, the thesis derives congruent policy recommendations for Croatia.

Acknowledgments

I would like to express my gratitude to my supervisor, Professor László Csaba, of Central European University, for his patience in answering my many questions, and his assured guidance. I am eternally grateful to my father, for his unconditional support, and to my aunt, for her helping hand. Also, to Lana, Ana and Claudia, for contributing to this work with their friendship and support.

Table of contents

Introduction

Foreign direct investment has been a salient issue for many years. Ample literature has been provided, especially for transition countries. In the Central Eastern European region, the Visegrád countries (Poland, the Czech Republic, Slovakia and Hungary) have been of interest due to their impressive export growth, largely stimulated by FDI. Croatia, mostly classified as a South-Eastern European country, belongs to the group of economic laggards; its export industry has been hardly existing and scarce FDI has found its way to the country.

A vast volume of literature on the Visegrád countries shows they have been studied in-depth. The literature on Hungary is especially abundant. On the other hand, Croatia does not seem to have provoked that much interest; it has been drifting somewhere between a politically unstable country, burdened by the heritage of war, and the ideal it was expected to achieve – catching up with other successful post-communist countries. It is still a puzzle, and, especially in respect of FDI, a laggard. However, FDI is often proclaimed an engine that would boost economic growth.

In this thesis I am applying the qualitative method of an in-depth comparative case study of Hungary and Croatia. By using descriptive analysis, I will abstract the foreign direct investment (FDI)-conducive policies Hungary has been implementing, in order to derive policy recommendations for Croatia. This analysis may provide policy recommendations not only for Croatia, but also to other post-transition countries which are laggards in respect to foreign direct investment.

I will rely on arguments of scholars who analyze transition economies: Dorothee Bohle and Béla Greskovits's (2012) types of capitalisms which developed out of transition economies, László Csaba (2005, 2012) and his analyses of transition economies, and Jan Winiecki's (2009) selection of works on export growth and competiveness of the newer member states of the

European Union (EU). Reports by the International Monetary Fund, the United Nations Conference on Trade and Development and the World Bank have been analyzed, as well as World Bank surveys. Macroeconomic data have been obtained from the aforementioned institutions, as well as from the respective countries' institutions, mainly central banks and bureaus of statistics. The time period adressed is 1992 until 2012, the latest data available.

My argument is that, in order to attract FDI to a small, open, post-transition economy, the following elements are necessary:

1. regulated judiciary and effective bureaucracy,
2. flexible labour code,
3. effective local and regional self-administration,
4. investment stimulation and
5. predictable economic policies with an emphasis on taxation policies.

Inherited industrialization capacities can be a grand advantage, but I argue they are not a necessary precondition, since greenfield investment and starting up new branches of industries are quite common. In this thesis, I am not touching upon the issue of investment promotion agencies and their promotion activities. Rather than that, I am focusing on the business environment itself, arguing that ensuring a friendly environment is a precondition in order to be able to promote investment. Due to the limitations of the thesis, I am also not analyzing monetary policies and exchange rate regimes.

I have chosen the cases of Hungary and Croatia according the method of difference, with FDI as the object of analysis. Among scholars who describe methods of case selection, I am relying on Stephen Van Evera's (1997) work. The author analyzes John Stuart Mill's 'method of agreement' and 'method of difference' (1997). The method of difference relates to choosing cases with similar general characteristics and different values on the study variable.

The cases share similarities in various aspects. The two countries have a long-lasting common history; they have co-existed in various forms of state unions since the twelwth century, the last one being the Austro-Hungarian empire. Observing the countries' political systems, they are both former communist, now democratic countries, as well as members of the EU. Resemblances in party systems can be noted as well: the Christian, conservative right and the post-communist successor left, have played similarly influential roles in both of the countries' political trajectories. Hungary started implementing reforms directed to the development of market capitalism as early as the 1980s. Croatia, as a part of Yugoslavia, was practicing the socialist 'self-management' model. Both countries were not considered typical examples of strict planned economies.

Today, they are both small, open economies but the difference among them in respect to FDI is self-evident. Hungary was considered somewhat a sensation after the fall of communism. It was the most popular country with Western investors, proclaimed as “most favoured nation“ (Martin 2013, 142), attracting big volumes of foreign capital. Croatia has, on the other hand, been considered one of the late-comers among the Central Eastern European countries, having hardly developed an export economy worth the name. Since it had missed the early FDI boom, one of the main reasons being the war for independence and weak state capacity, it was expected to speed up and catch up with the rest. Years of implementing policies not oriented towards attracting FDI today have inevitable consequences, in the form of an absence of an FDI-conducive environment and the subsequent lack of economic growth.

This analysis addresses countries which both passed the initial phases of the transition process, the so-called SLIP agenda - stabilization, liberalization, institution building and privatization (Csaba 2011), a long time ago. At the time when FDI in Hungary was already in ascent, the whole political setting of Europe, as well as the world economy, were much different than today. Therefore, policies recommended to Croatia today cannot be identical to the ones implemented in Hungary at the beginning of the 1990s. However, there are more recent policies which, despite each countriy's specificities, can be applied to Croatia as well. The contribution of this thesis will be summarizing FDI-conducive policies implemented in a successful case, Hungary, and applying them to a less successful one, Croatia. Croatia has already received many policy recommendations from various experts and institutions, such as the World Bank. This thesis will abstract important recommendations with a reference to FDI-attracting policies in Hungary.

The thesis is structured in four chapters. The first chapter provides the theoretical framework. The second chapter is comprised of the case study of Hungary, while the third encompasses the case study of Croatia. The fourth chapter brings a comparison of the elements necessary for FDI in both countries, and is followed by a conclusion.

Chapter 1 - Literature review and theoretical framework

In this chapter I will present the arguments of the works of the main scholars I am relying on, after which I will introduce some of the main theoretical arguments on FDI, its definition and the effects it has on the host country. Later I will adress the role of the state and briefly touch upon findings about privatization and export growth in transition economies.

There are three types of transition economies in Europe, as classified by Dorothee Bohle and Béla Greskovits (2012): the pure neoliberal type in the Baltic states (Estonia, Lithuania and Latvia), the embedded neoliberal type in the Visegrád group (Hungary, Poland, the Czech Republic and Slovakia) and the neocorporatist type in Slovenia. Croatia's economy resembles more the embedded neoliberal type of capitalism. Sustaining a relatively generous welfare state, Croatia was very much dependent on tourism and had not embedded FDI-conducive policies into its agenda. A weak state, captured by various domestic groups, along with crony capitalism, failed to act in the interests of national economic development. Weak states can, as Bohle and Greskovits argue, attract only 'impatient' foreign capital, because they cannot offer the variety of resources and services necessary. As far as industrial structure is concerned, Hungary had inherited some complex-manufacturing systems from the socialist era, while Croatia refused to engage foreign capital into its few manufacturing sectors, such as shipbuilding. Similar to Croatia, Hungary also featured a generous welfare system which severely burdened the budget (Bohle and Greskovits 2012).

In his edited volume *Competitiveness of New Europe*, Jan Winiecki (2009) gathered works of relevant authors who place a strong emphasis on foreign trade and the role of foreign direct investment in the economic performance of the new(est) member states of the EU. Javorcik and Kaminski write about the variety of direct benefits from FDI such as significant increases of total factor productivity, as well as the indirect ones, known as spillovers. High quality requirements of multinational companies (MNCs) generate upgrading efforts on the suppliers. Two types of linkages between domestic firms and multinationals are created: buyer-driven value chains, managed by large retailers, and producer-driven value chains, managed by manufacturing MNCs (Winiecki 2009).

Looking at the longer run, there is an immediate relationship between FDI and export growth. Most markets in the (CEE) region are too small to be of interest to big investors; also, in the era of global sourcing, it is almost impossible to join the multi-dimensional, multi-layer web of inter-firm relations, if the old socialist habit of 'do it yourself' dominates (Csaba 2005). Around one third of OECD trade is organized as intra-company flows within the network of multinational companies and their subsidiaries, hence the expansion of trade both in the former CMEA area and in the East-West context could be stimulated by FDI (Csaba 1994).

1.1 FDI and its effects

The United Nations Conference on Trade and Development provides the following definition of FDI: "[…]FDI refers to an investment made to acquire lasting interest in enterprises operating outside of the economy of the investor. Further, in cases of FDI, the investor´s purpose is to gain an effective voice in the management of the enterprise." (Unctad n.d.) The foreign entity, or group of entities investing are referred to as 'direct investors', while the branch or subisidiary in which direct investment is made is referred to as a 'direct investment enterprise'. A threshold od 10 percent of ownership is suggested to qualify an investor as a foreign direct investor (Unctad n.d.).

Beyond the initial macroeconomic stimulus provided by the actual investment, FDI affects growth by raising total factor productivity and the efficiency of resource use in the host economy, which works through three channels: spillovers, linkages between FDI and foreign trade flows and other externalities vis-a-vis the recipient country business sector, as well as the direct impact on structural factors (OECD 2008).

Effects of FDI can be positive or negative effects. In his classification, Theodore H. Moran (1998) describes them as the 'benign and the malign model of FDI and development'. The benign model views foreign investment as a means to set out poverty. „Low levels of productivity lead to low wages, which lead to low levels of saving, which lead to low levels of investment, which perpetuate low levels of productivity. Under reasonably competitive conditions, which the foreign presence may enhance, FDI should raise efficiency, expand output and lead to higher economic growth in the host country“ (Moran 1998, 19-20). The malign model contributes to “[…]lower domestic savings and investment by extracting rents and siphoning off capital through preferred access to local capital markets and local supplies of foreign exchange. Instead of closing the gap between investment and foreign exchange, they might drive domestic producers out of business and substitute imported inputs“ (Moran 1998, 21).

Regarding the direct effects of FDI, among many others, the research by Arnold and Javorcik (2005) shows that receiving FDI not only leads to an immediate boost of productivity but also that the improvements continue to take place in subsequent periods (Javorcik and Kaminski, in: Winiecki 2009). Foreign investment through privatization enables restructuring of companies by introducing new management practices and corporate governance, cost saving measures and other, in order to increase overall efficiency (Sohinger and Harrisson 2004). Indirect effects of FDI, the so called 'spillovers' from FDI can work in two ways – vertically and horizontally. Vertical linkages are seen in the form of buying high percentage of input from domestic suppliers. Assistance in the form of support can be seen in the form of advance payment and financing, employee training, help with quality control etc. (Javorcik and Kaminski, in: Winiecki 2009).

Horizontal linkages are created through demonstration effects, inducing other domestic companies to restructure in a similar way. Horizontal effects can work in a positive or negative fashion. If the market structure is satisfactory and the technology gap is not too large so that local firms can imitate and compete with foreigners, positive development can be expected. In case of a too big of a difference, foreign investment can crowd out local firms. Another possibility of negative consequences is implementing an unfortunate host policy mix which deteriorates the competitive structure in a certain market, even an economy as a whole; if foreign investors negotiated deals with governments which actually hurt the domestic economy, even teaming up with local oligopolists to lobby against stricter antimonopoly laws and regulations (Sohinger and Harrisson 2004).

The traditional paradigm was hostile to FDI and capital account openness in general; it was a coherent worldview for most of the 1950-90 period. Now the critical mainstream accepts that reliance on FDI is perhaps inevitable. The negative effects of FDI can be little room for national industrial or structural policies, as well as maintaining a low rank role of the supplier in the value chain. There is also a danger of failure if governments implement policies aimed specifically at bolstering various detailed aspects of competitiveness. If the state wastes its limited administrative capacities on special interest policies, it will neglect preserving macroeconomic stability (Csaba, in: Winiecki 2009).

The role of FDI in a host economy is undisputably significant, especially in transition countries. FDI is often regarded as a means to push countries' economic growth, although some, like Slovenia, have developed even without a strong orientation towards FDI. “Still, the ability of post-socialist countries to integrate effectively into the global flows of capital and attract FDI after 1989 was, arguably, a crucial aspect of the transformation to the market order. It [FDI] has been advocated by prominent international organisations as an engine of transition to the market and a powerful force for the integration of Central and Eastern Europe into the global economy“ (IMF 1997; Unctad 1998, in Bandelj 2010, 482).

In *Competitiveness of New Europe,* Beata S.Javorcik and Bartlomiej Kaminski (2009) dwell into the issue of how to attract FDI and maximize its benefits. As the authors argue, multinational firms are more knowledge-intensive and productive than their local counterparts, relying on new technologies and well-established brand names. They undertake a large share of the global research and development (R&D) efforts: 62.5% of business R&D in Hungary has been undertaken by foreign affiliates. The authors define the term “global commodity chain“, i.e.the international production and distribution network, distinguishing between “buyer-driven“ and “producer-driven“ commodity chains (2009, 105) which represent different modes of integration and participation in global division of labour. “Buyer-driven“ networks exist in industries, labour-intensive consumer goods' sectors, such as apparel or furniture. “Producer-driven“ networks divide the value chain into smaller components and move them to countries where production costs are lower. The automobile industry is a classic example of producer-driven networks, encompassing a multi-layered production systems, partitioning the value chain into smaller components which are produced in lower production cost countries. Another example is the IT industry, which is, as well as the automobile one, a vertically integrated sector with two-way flows of parts and components for further processing and development across firms in various countries.

Entry into producer-driven networks is rather inconceivable without FDI, because, in those networks, they are efficiency seeking and vulnerable to the quality of broadly defined business environment. A high correlation is found between producer-driven network exports - the IT and automotive industry, and the size of FDI inflows. Countries with larger FDI manufacturing stocks per capita are those with a higher share of skilled labour-and capital-intensive products in total exports. MNCs seem to have been attracted by the high-labour force availability (Javorcik and Kaminski, in: Winiecki 2009). The degree to which FDI can facilitate the transfer of new technologies to the host economy depends on many factors: the absorbtive capacity of the receiving economy, including the level of human capital and the existing technological infrastructure; how the affiliate company fits into the parent's company global strategy and others (Sohinger and Harrison 2004).

From a theoretical viewpoint, an 'investor friendly' institutional environment of an economy, that is the formal and informal norms which shape the behavior of economic agents, secure property rights and allow foreign firms to enter a particular market, is frequently seen as a necessary condition for a country to receive FDI (Bellak, Leibrecht and Liebensteiner 2010). Ensuring 'investor friendly' conditions is a complex process. However, such an environment is then conducive not only to foreign, but to domestic investment as well. Therefore, the effort invested in reforming policies ought to bring multiple benefits.

1.2 Role of the state

Policy measures require a capacity of pursuing and implementing policies on the part of the state. According to Shafer (1994), the strength and capacity of a state can be measured by the level of autonomy – the extent to which it is distinct from other actors; absolute capacity – the scope under which it has the authority and means to extract and deploy resources: bureaucracy, monitoring and regulatory capabilities; and the relative capacity it enjoys – interests, resources and capabilities of salient social actors.

The role of the state is a particularly delicate issue when it comes to transition economies. Socialist economies were not market economies. They did not have the perks of the invisible hand of the market in regulating the economy. Therefore, in the period of transition, the state was required to 'step in' and enforce some sort of regulation. In other words, the state had to have been capable of performing such a task, which was often not the case. Roderick

Martin refers to László Murakozy, who argues that in “[…]transforming societies, it is not the market that shapes the state[…]the state shapes and creates the market[…]“ (quoted in Farkas 2009, 126), and to Fliegstein (2001, 3-4) who argues that “Without stable, more or less non-rent-seeking states, modern production markets would not exist“ [in Martin 2013, 198].

Bohle and Greskovits (2012) argue it is up to the political system in general, and the state in particular, to direct capitalist development to sustainable paths. In case there is no required coordination nor manouvering capacities, there is bound to be economic disorganization, social disintegration and political crisis.

From the strength of the state, conditions for creating an environment conducive to investment are derived, such as a regulated judiciary, taxation policies, investment stimulation and others. For example, implementing a flexible labour code would mean the state has managed to successfully negotiate with interest groups, in this case, employers and trade unions, with the purpose of establishing conditions prospective to economic growth.

1.3 Privatization

> Insufficient domestic savings can be overcome by selling SOEs to foreigners. The potential of a 'sell-out' to foreigners has, however, been strongly resisted everywhere. Politically it has proved unacceptable to sell a large portion of industrial assets, notably the 'jewels', to foreigners owing to the fear of losing national control. Foreign investors are anyway likely to buy in most countries only at rock-bottom prices, since the risk of a reversal of reforms or a future (re)nationalisation can never be eliminated (Gros and Steinherr 2004, 79)

People are often afraid foreign firms will buy assets at low prices, that foreign owners will be less inclined to save jobs in outdated factories and that they will keep wages relatively low, which can all happen from an individual's firm point of view. However, what matters is the macroeconomic aspect: if workers want to have rising net real wages, they would have to support productivity growth in firms and competition in goods and labour markets, which would help check price increases and raise wages across all sectors. Governments would then have to keep tax rates low, by avoiding rising subsidies to unprofitable SOEs and reduce the foreign debt by gradually improving the terms of trade. One would have to promote economic growth, for which MNCs, with their transfer of technologies, dominated worldwide by intra-firm transactions, are vital (Csaba 1994).

The aforementioned argument suggests privatization of some form is inevitable if one's goal is to ensure a functioning market economy. A change of an economic system to a market economy is a thorough one; state ownership of companies is not anymore the 'only game in town'. Privatization is a delicate issue, and certain parts of the population are bound to be unsatisfied with it. A survey conducted in 28 post-communist countries indicates that more than 50 percent of the population in each of the 28 countries, as well as over 80 percent of all respondents, support some form of revision of privatization. However, opposition to privatization should not be equated with support for re-nationalization (Denisova et al. 2012).

1.4 Export growth

The impact of structural changes on economic growth is derived from the shift of resources from the primary to the secondary, i.e.to the manufacturing and, further on, the service sector. Openness to trade and FDI, the two influencing a country's industrial structure, amplifies this effect (Sohinger and Harrison 2004). It is often argued currency depreciation is a means to induce growth, by enabling cheaper exports. It is thus interesting to note that the appreciation of the Czech Republic, Hungary and Poland's national currencies against the Euro in the 1990s did not worsen their export performance. The reason behind the appreciation was actually an increase in productivity growth and a declining productivity gap between the three countries and the EU-15 (Wziatek-Kubiak, in: Winiecki 2009).

Chapter 2 - Case study: Hungary

In this chapter I will address Hungary's transition, economic and FDI trajectories, I will look at the role of MNCs in export growth, analyze the welfare state and the Labour Code, describe the privatization processes and taxation policy. Finally, I will refer to FDI promotion and obstacles.

There is exuberant literature on the process of transition in Hungary, out of which I am referring to three works. László Csaba explains why Hungary can be considered a success-story in terms of transition economies, although the 2007-2011 period of the crisis is omitted from this evaluation. It had managed a peaceful transition from communism to democracy and a gradual and organized accession to the EU. Opening up of the domestic market was irreversible and institution building was shaped by the adjustment to EU structures and a swift IT revolution and deregulation. What is rightfully questioned is whether the mentioned outcomes were a product of conscious decisions or simply a result of the drifting and improvisation that has prevailed since the EU accession, since no further radical measures, except fiscal re-balancing, have been taken since 1996 (Csaba 2012).

János Kornai (1996) emphasizes four specificities of Hungarian development: placing great weight on raising material welfare and curbing the fall in living standards, a welfare state covering the entire population, a gradual process of transformation and a peaceful transition.

What is also important to note is that Hungary has (had) generous welfare schemes that have helped large social groups to avoid, or at least slow down the decline, to underclass status. It is the very compromise between market transformation and social cohesion that makes Hungary's neoliberalism embedded and distinctive (Bohle and Greskovits 2012).

2.1 Economic trajectories

The period between 1949 and 1953 was the only time the classical socialist system was in place. During that period, an almost complete nationalisation of property rights was in place, providing ground for a forced industrialization. After the 1956 revolution, János Kádár came to power where he will have remained for the next 32 years. Public spending was directed from physical investment to the material welfare of citizens and this type of governance was referred to as 'goulash communism' (Benczes 2011).

After 1968, a series of reforms named 'New Economic Mechanism' were implemented, the first one from 1968-1973, with the aim of increasing the efficiency of the economy by introducing market incentives at company level: managers were given more discretionary power, which, along with other reforms, culminated in an accelerated growth performance. The NEM was interpreted as a tacit agreement between the citizens and the party: in exchange for a relatively high standard of living and a relative degree of freedom, citizens had to remain loyal to the Party and did not question the *raison d'etre* of the socialist regime itself (Benczes 2011). Liberated from the slavery of central planning, Hungarian corporate bosses turned into businessmen by default. The first oil crisis in 1973 spoiled the short lived success and a second reform cycle was triggered, from 1979-1982; informal activities, the so-called 'second economies', were legalised and small, private firms were officially recognized. Already by the mid-1980s, more than 10 000 new small enterprises existed. In order to avoid an open crisis, a three-year programme of liberalization and external opening was implemented in 1989: state monopoly on foreign trade and currency transactions was abolished, as well as wage and price controls and spontaneous privatization started (Csaba 2012).

In the period from 1989-93, Hungary had suffered the so-called 'transformational recession'. According to János Kornai (1994), all post-socialist countries had undergone a severe recession in the 1990s, with recovery beginning by 1993, except in the case of Poland.

He describes the main elements: a switch from a sellers' market toward a buyers' market, a transformation of the real structure of the economy, disruptions in coordination, financial discipline and enforcement of efficiency and a backwardness of the financial sector (Kornai 1994).

After the transformational recession, growth resumed in 1994, a harsh adjustment programme was implemented in 1995 and GDP continued to grow in the period from 1996-2000. The slight positive growth continued until the 2009 crisis. Fiscal adjustments took place in 1995 – the so-called 'Bokros-package', in 2006 and between October 2008 and May 2010 (Csaba 2012). Drying up of global liquidity due to the crisis was a problem for Hungary. The country was financing its account deficit by foreign borrowing, and the situation was further aggravated due to the currency devaluation. Fall of demand in the EU hit Hungary in the beginning of 2009, since it was highly dependent on manufacturing exports; the volume of goods exported fell, as well as industrial output and GDP (Myant and Drahokupil 2011).

Hungary was the largest recipient of FDI in New Europe in 1990-95, the only recipient among New Europe's economies in 1990, and it accounted for 80 percent of total FDI flows in 1991 (Javorcik and Kaminski, in: Winiecki 2009). Roderick Martin argues that, once Hungary had become established as the “most favoured nation“ (Martin 2013, 142), the flow of FDI coming into the country had become auto-progressive, with past inflows generating higher current and future flows. FDI was more than half of its GDP in 2004 and 2005. The initial investment was primarily in manufacturing, with expansion in services, finance and financial servces, and retail distribution after 2000. By 2008, the majority of the FDI stock was being invested in services; 87.06 percent (OECS, in: Roderick 2013). Starting from US$9 billion in 1989, exports rose up to US$107.2 billion in 2008. FDI stocks peaked at €6.2 billion in 2006 and foreign ownership accounts for approximately 40 percent of Hungarian assets, as well as 80 percent of the country's exports (Csaba 2012).

An answer to Bohle and Greskovits's question *'Why have complex industry transnational companies preferred Visegrád countries over other CEE countries*?' can be found in the following: export-oriented, complex industry FDI first started flowing towards those post-socialist economies whose initial production profiles were relatively complex - intensive in technologically sophisticated physical capital and human skills. In the case of Visegrád countries, it meant that specializing in the automobile, machinery or electronics idustries would attract FDI. Yet, their main advantage was locational competition stemming from inherited complex-manufacturing experience. The authors also question how the foreign investors managed to choose between the Visegrád countries. It was the institutional advantages, namely, the similarity to the West, industry upgrading versus deindustrialization, 'follow the leader' (more foreign firms following), clustering of complex industries in the same areas and generous subsidy packages that were crucial for making the decisions (Bohle and Greskovits 2012).

2.1.1 Export growth and the role of multinationals

The pioneering role of Hungary gradually vanished from 1999 onwards; the privatization process came to a halt in the 1998-2004 period, which was interesting, considering that, in general, FDI literature and business experience would forecast that capital invests where it has already invested (Csaba 2005).

Anna Wziatek-Kubiak (2009) argues that Hungary, the Czech Republic and Poland are considered to be the most important players on the EU market, among the New Member States (NMS), constituing 75% of NMS' trade with the EU-15. The countries have had a visible increase in the quality of most products, as well as an increase in the number of high-quality industries and shares in their total exports. However, Poland and the Czech Republic differ significantly from Hungary, which has had a higher share of high-quality industries. An important point the author makes is that, contrary to the usual 'recipe' of currency depreciation as a means of maxing exports more attractive, the *appreciation* of the three national currencies during the 1990s resulted in improvements in the competitiveness of their exports (Wziatek-Kubiak, in: Winiecki 2009).

By 2010, Hungary had, alongside with Poland, Romania and the Czech Republic, become incorporated into the internationalizing strategies of MNCs through acquisitions, joint ventures and the development of greenfield production facilities (Martin 2013). MNCs are considered important actors in FDI parliance. On the one hand, they can bring significant benefits to the host country; on the other hand, national governments often need to put in a lot of effort and invest a lot in order to atract them.

Hungarian economists such as Kádár, Inotai and others, have concluded that even moderately sophisticated manufactured goods cannot be successfully exported unless the country was fully integrated into MNCs' international sales networks; they argued Hungary had no chance to increase its exports if it continued to produce manufactured end-products, but that an increase could be reached through the integration into the MNCs' network (Mihályi 2000).

2.1.2 Macroeconomy

Since the introduction of the 1968 economic reform, Hungary had suffered from British-type stop-go cycles, which meant that good years of expansion repeatedly ended in a balance-of-payments crisis. The strategy of import-substitution worked in the wrong proportions: 1 percent GDP growth required a larger than 1 percent export growth, which meant an even larger growth of (Western) imports was needed (Mihályi 2000). Hungarian GDP had the biggest drop in 2009, with a fall of -6.8 percent, after the country was hit by the global crisis in 2008. In 2012, investment dropped to its lowest point in 10 years, with the exception of the auto industry which is strongly connected to the German supply chain (IMF 2013).

Measures of fiscal consolidation were implemented to fight the fiscal deficit; there was an increase in the standard VAT rate from 25 to 27 percent (the highest rate in Europe). New taxes on banks, retail, telecommunication and energy sector were also introduced.

The average unemployment rate of 10.72 percent in the 1991-1995 period started decreasing throughout the years, reaching the lowest rate of 5.7 percent in 2001. Again, due to the the 2008 crisis, the rate started rising, exceeding the early 1990s rate, with 10.9 percent in 2012 (World Bank). Positive movements seem to be on the way: Eurostat's report for January 2014 indicates a significant decrease of the rate: between December 2012 and December 2013, the rate dropped from 11.1 percent to 8.8 percent (Eurostat 2014).

2.1.3 FDI trajectories

After the change of the regime, Hungary entered into a sort of a contest with other countries in the region. "And bidding wars there were[…]policies of attracting FDI became a major hallmark of the Visegrád countries' embedded liberal regimes, bringing intraregional rivalry to a hitherto unknown level" (Bohle and Greskovits 2012, 167-168).

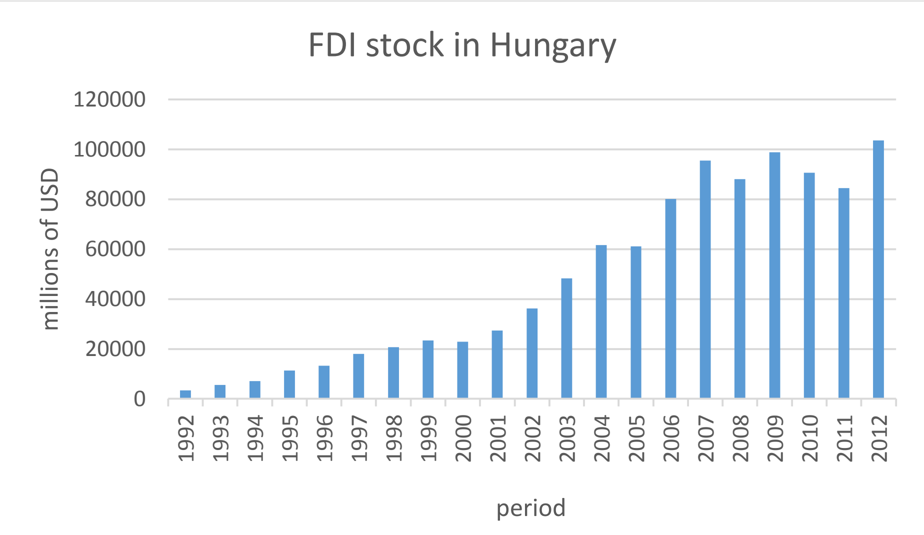

Figure 1. FDI stock in Hungary, 1992-2012, in millions of USD

Source: Author's adaptation, Unctad,

http://unctadstat.unctad.org/TableViewer/tableView.aspx

As shown in Figure 1, there has been a general steady increase of FDI stock, with a significant drop after 2009, when the crisis hit Hungary. In 2010 and 2011, stock was declining, and it started growing again in 2012.

In 1997, Péter Farkas analyized FDI by sectors, of which I will emphasize the most important ones. In the food industry, there was over 50 percent of foreign capital, with almost total ownership in confectionery, vegetable-oil production, soft drinks production and the tobacco industry. The chemical industry experienced some negative consequences, such as the case of the Vegetable Oil and Detergent Producing Co., whose foreign owner closed down sections of the factory, dismantled some modern equipment and took it abroad. Foreign investors opted for investments in the pharmaceuticals industry due to the companies' presence on the world markets thanks to the original products, high standard of scientific and technical knowledge and notable R&D capacity that operated cheaply by international standards. Sanofi invested in Chinoin and Gedeon Richter was privatized in 1995. Investments in the vehicle industry were typically greenfield, mostly assemblies of products whose manufacture can be considered product innovation and the installation of production lines a technological innovation. There was a greenfield investment by Philips in Szekesfehervar, and General Electric's investment in Tungsram (Farkas 1997).

Looking at latest available data from 2012, the biggest individual investors were Germany, Luxembourg, the Netherlands and Austria (Central Bank of Hungary n.d.). In the same year, 56.214.5 million euro of FDI stock were investments in services: management consultancy activities, wholesale and retail trade, real estate, financial intermediation and telecommunication were the most important activities. 15.786.3 million euro was invested in manufacturing, of which more than 2 million in pharmaceuticals, computer, electronic and optical products, and vehicles and transport equipment (Central Bank of Hungary n.d.). Figure 2 shows the rise of FDI in the services sector, in comparison to manufacture.

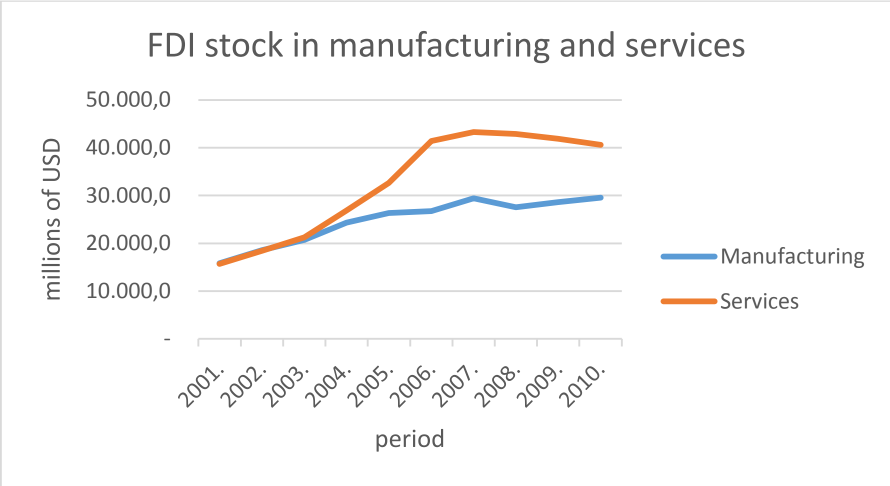

Figure 2. FDI stock in manufacturing and services, from 2001 until 2010,

in millions of USD

Source: Author's adaptation, Central Bank of Hungary,

http://english.mnb.hu/Statisztika/data-and-information/mnben_statisztikai_idosorok/mnben_elv_external_trade/mnben_kozetlen_tokebef

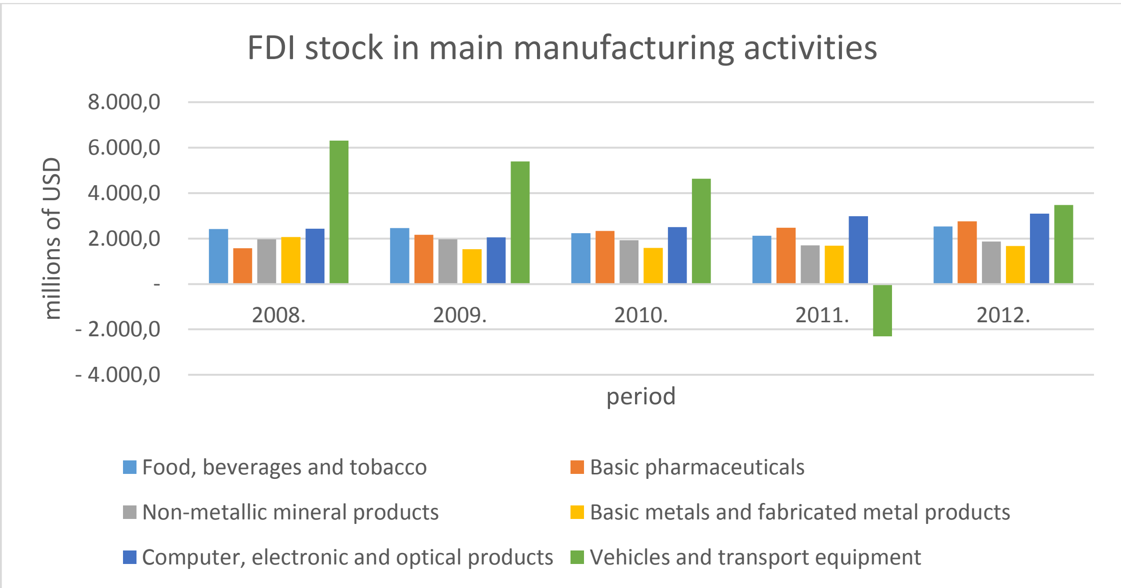

Figure 3. FDI stock in the main manufacturing activities, in millions of USD

Source: Author's adaptation, Central Bank of Hungary,

http://english.mnb.hu/Statisztika/data-and-information/mnben_statisztikai_idosorok/mnben_elv_external_trade/mnben_kozetlen_tokebef

As seen in Figure 3., after the 2008 crisis began, vehicles and transport equipment investment had the most significant fall of all investments, and started recovering only in 2012, while FDI in manufacturing pharmaceuticals resumed a fairly stable growth (Central Bank of Hungary n.d.).

Despite criticism of the recent economic policies, there have been several recent investments: Procter&Gamble's new greenfield factory in Gyöngyös, with an investment of 19 billion forints, was inaugurated in March 2014. The same month, the Danish Lego Group opened a new plant in Nyíregyháza. Iti s a EUR 200 million investment which will create 250 new jobs, in view of which Lego will employ a total of 1,500 people in Hungary (Hungarian government 2014).

Tungsram light-source manufacturer is a positive example of FDI often referred to in the literature. A factory established in 1896, with a five to six percent market share in Western Europe and two to three percent globally, was famous for the 1903 invention of the incandescent lamp. Due to problems such as a weak financial position, old technology, hazardous waste and other, it was in need of fresh capital, available only via a foreign investor. General Electric stepped in, acquiring the majority in 1990 and then fully buying out the company in 1994, renaming it into 'GE Lighting Tungsram' in 1996. The company now holds 16 to 17 percent of market share in Western Europe, after Phillips and Osram. All of GE's energy-saving lighting sources are now produced in Hungary and all of GE's light source research has been done in Hungary since 1994. Tungsram's privatization is considered both an excellent strategic investment for the multinational as well as something in Hungary's national interest (Marer and Mabert 1997).

2.2 Welfare state

When analyzing Hungary's macroeconomic situation, one should not omit the significance of its external debt, starting already in 1968, when advanced reforms were adopted. Istvan Bencezs (2011) argues the general budget was used as a buffer to compensate losers of (micro)economic and political reforms. Household transfers, such as family and child allowances, sick pay, disability pay or early retirement payments, are more generous than in most of the older EU member states it had (Benczes 2011). Peter Vanhuysse writes about an „abnormal pensioner boom“ (Vanhuysse, in: Bohle and Greskovits 2012, 155). An over-generous welfare state, characteristical for other transition economies as well, is not a novelty for Hungary; it is a problem that has been present for a long period of time and needs to be resolved.

2.3 Labour Code

After partial consultations, the unions' amendments and protests, the amendment of the Labour Code, initiated by Orbán's government, was finally passed in December 2011 and partially came into force in July 2012 (Eironline 2013). It has increased the possible period of probation to three months and it now makes it possible for employees to be told about the termination of their employment during a period of sick leave. It is no longer the duty of employers to re-employ unlawfully dismissed employees at the employee's request. The newly-regulated working time and shift supplements allow employers to be more flexible and to cut overtime costs when there is a sudden surge in labour force demand (Eironline 2013). The compensatory burden on employees for causing harm to the employer, for example through negligent work, has increased. It also stipulates that the employer is only liable for damage which is within the overseeing capacity of the employer, and which the employer could have averted (Eironline 2013).

Probably the most important changes for unions in the new code are cuts to the entitlements and rights of union activists; for example, only up to 5 union officials are entitled to legal protection, depending on the size of a workplace – the former code provided legal protection to all officials (Eironline 2013). Works councils now have the right to conclude works agreements with the employer in cases where there is no collective agreement in force and no representative union present at the workplace. The works agreement may regulate terms and conditions of employment in a collective agreement but it cannot regulate wages and other forms of pay (Eironline 2013).

Employers have expressed satisfaction with the new Code, as opposed to trade unions. The idea behind the Code was to allow more flexible regulation of work, so firms would more easily regain competitiveness and have more possibilities for cost cutting (Tóth 2012). A Labour Code that helps and protects not only the employees but also the employers is often stated as one of the elements conducive to developing competitiveness of an economy. It is therefore no surprise Prime Minister Orbán has provided such an explanation for the implementation of the aforementioned changes. As important it is for the domestic economy, it also plays a role when it comes to foreign investors; favourable conditions for employers matter.

2.4 Privatization

Péter Mihályi reminds that, prior to World War II., industries of Hungary and other CEE countries were dominated by foreign investors, and that post-communist privatization only re-created the pre-1945 ownership structures (Mihályi 2000). At the end of the 1980s, company managers in Hungary engaged in the so-called 'spontaneous privatization'; they separated certain assets of the old SOEs to build new enterprises whose shares were then 'sold', either to the managers themselves or other domestic or foreign investors. The State Property Agency (SPA) was set up in March 1990 to stop this and to try to re-centralise the proces via the First and Second privatization programmes. Companies were still in the hands of the SPA but they were now in private form. 'Self-privatization' was taking place from 1992-93, shifting work from the SPA to independent consulting firms. SPA was dissolved in 1995 and the Hungarian Privatization and State Holding Company (HPSHC) took over all the tasks (Schöllmann, 2001).

> It was only around 1994/95, when Hungarian privatization officials understood that selling virtually each and every 'crown jewel' of the Hungarian economy to the 'multies' was a blessing in disguise[…]this was the only conceivable way to put Hungary firmly on an export-led growth path[…] (Mihályi 2000: 3).

By August 1997, 75 percent of the GDP was produced by the private sector (Lavingne 1999, in: Martin 2013). The Enterprise Law was brought in 1989, establishing the legal framework for limited liability companies, recognizing the state and private sectors as equal players in the economy (Rona-Tas 1997, in: Martin 2013).

2.4.1 Idea of selling rather than distributing

Hungarian privatization differs from other countries such as, for example, the Czech Republic, where a significant part of the state property was handed free of charge to citizens or to managers and employees. The biggest benefit, besides yielding significant fiscal revenue, is the fact that such privatization produces favorable conditions and fairly strong incentives for reorganization and a new, effective style of corporate governance; privatized Hungarian firms soon surpass state-owned firms in their performance (Kornai 1996).

Small privatization began already under the socialists, by leasing and sale through auctions, and was expanded after 1989. Foreign participation was well received. However, due to combining reliance upon management initiative with a case-by-case approach and a desire to maximize revenue, the process turned out to be fairly slow (Martin 2013). The strategy was criticized by the majority of the Western 'transition-experts', and the approach was referred to as 'crazy and disastrous' even 3 years after its launch. In 2002, the European Comission assessed the progress of the privatization process, showing that the state continued to own 162 companies, of which 97 were classified as 'strategic' (Martin 2013).

2.4.2 Foreign strategic owners are good

Due to limited domestic capital, financing privatization was done through foreign investment; 96 percent of private capitalization was provided by Western investors. An example of a strategic investor making significant changes in a company is the one of the earlier mentioned Tungsram light source manufacturer. Apart from General Electric improving Tungsram's position in the market, in ways the company could have never done by itself due to a lack of assets, it also changed its corporate culture.

Péter Farkas describes several positive effects of FDI on research and development. With greefield investments, which comprised almost half of the investment in Hungary, foreign capital translates into relatively modern techniques; it employs new organizational and technological processes in firms, which starts off an innovation process. R&D sections of firms are retained, even ammeliorated, and innovation may, although rarely, pass onto local medium and small-sized firms that gain orders from local or foreign units of international groups (Farkas 1997).

All of the aforementioned benefits were the ideas based on which Hungary decided upon its transition strategy. It did not choose an inward-oriented approach because there was a different, clearer vision; FDI was a tool that would bring 'upgrading' of old structures. Bohle and Greskovits (2012) argue Hungary had a high external debt and, because of its reformers preference for disciplined debt service, it was highly dependent on hard currency cash receipts which were only available from exports and privatization. It was one of the key motives behind the strong export orientation and privatization through sale (Bohle and Greskovits 2012).

When it is not the case of greenfield investment, Farkas reminds that analysts argue FDI does *not* provide a technical leap-forward. In case of buy-outs, there is typically partial technical development and improvement of the information system, and the cheapness of the labour force means that some assembly does not need to be automated, which might account for lower capacities of Hungarian facilities in comparison to their Western counterparts. Technical innovation associated with FDI is limited, but very often foreign investors acquire companies that are *already* strong on expertise (e.g.chemicals or pharmaceuticals), which is then exclusively available to the multinational group (Farkas 1997).

2.4.3 Privatization does not imply competition

At that time (1993), the power plants were owned by a state run shareholding company, and the distributor companies were in the ownership of the Hungarian Privatization and State Holding Company (Bakos 2001). As the debt was accumulating, the state decide to privatize the energy sector. It was a rash decision, made by the government, without the consent of the Parliament. The government promised to purchase electricity from the new owners with long-term contracts (20-25 years) and guaranteed a stable eight percent profit margin. Despite not having the majority of the shares until the second round of privatization, due to the government's decision, the investors managed to ensure a majority through buying out employee-shares or increasing capital. The foreign share in registered capital was 32 percent in electricity generation and 67 percent in supplying (Bakos 2011).

The crucial lesson is that privatization should be carefully planned. Rash decisions often lead to future complications, as was the case of introducing cost-based prices with an eight percent profit for the period of 5 years. The goal could not have been achieved by the proposed deadline, which was a shock for the citizens, since they had to withstand price increase.

2.4.4 The car industry

On the one hand, the collapse of communism provided ample opportunities to the auto industry MNCs: there was a strong pent-up demand by local consumers who had endured lengthy queues for low-quality cars throughout the communist years, a geoFigureic proximity to the much bigger markets and a highly skilled and comparatively low cost labor force. On the other hand, the legacies of the communist period presented MNCs with special challenges (Bartlett and Seleny 1998). Those legacies were entrenched in all areas of production; it was an outdated system that functioned based on the principles of a different economic framework. Investing meant taking a hold of what was old and turning it into something new.

Despite the necessary structural changes that would have to take place, several MNCs decided to settle in Hungary: Ford established its electronics components plant in Székesfehérvár, GM/Opel placed its auto assembly and engine plant in Szentgotthárd, Audi's engine factory was built in Györ, as well as Suzuki's assembly plant in Esztergom. Having to import parts from Japan and not enjoying the free-trade conditions as the European companies, Suzuki was granted many concessions: a five-year tax holiday, renewable for an additional five years, free land at the Esztergom site, state subsidies for worker retraining and infrastructural development and grants to facilitate technology transfer to local parts suppliers (Bartlett and Seleny 1998).

> The TNCs that invested into the Hungarian automotive industry have developed many linkages with the domestic economy. About 250 local companies supply parts and components to the companies in the automotive industry. The shares of local suppliers in total inputs vary across the four automotive companies. At present, in the case of Opel and Audi, they remain below 5 percent. The other extreme is represented by Suzuki, which has a network of over 40 suppliers, and an overall local value-added of 53 percent (OECD, in: Unctad 2001).

One of the reasons of a limited multiplying effect of integrating Hungarian suppliers into a global competitive system might be that small and medium-sized firms, which are important parts of technological innovation, are not oriented towards industry, thus the network of subcontractors scarcely exists. According to Arva, in classical assembly-type plants such as in engineering (mainly vehicle components), despite high rates of domestic supply, the major parts of production, namely, R&D, projecting, marketing and product development, stay in the capital-exporting country, while less creative activities are located in the recipient country (Arva 1995, in: Farkas 1997). There is thus still room for improvement and enlargement of the share of local suppliers in production processes.

2.4.5 A less successful privatization case

An unsuccessful privatization example is the one of the Ikarus bus factory. In 1989, it was producing some 12.000 units, employing around 8.000 people. After attempts to sell it to an interest group of Russian transportation companies, it was finally bought by Gábor Széles in 1997 (Filatotchev et.al. 2003). However, the upcoming financial crisis left the company in a need for a strategic investor. It was then fully bought out by the Iveco-Renault consortium, which did nor encourage the company's development and expansion, as expected. Instead, production was cut back and eventually fully discontinued in 2005. In 2007, the former owners re-purchased the company and engaged into structural rebuilding (The Budapest Times 2011). The Ikarus case demonstrates how, despite expectations and promises made by foreign investors, the restructuring of privatized companies is not always accomplished, leading possibly to a complete shutdown of production.

2.5 Taxation policy

Although countries often attract investors by lowering corporate taxes or promising tax holidays, a stable and predictable taxation policy is relevant, not only for domestic but for foreign investors as well. Long term financial projections can involve a certain leeway, but rash changes of taxation policies bring a feeling of uncertainty to those who wish to invest in the respective country. In June 2010, the Hungarian government announced the introduction of 'crisis taxes', targeting banking, energy, telecommunications, and retail sectors. “Originally unveiled as three year, limited duration[…]in November 2010, the government acknowledged that the 'crisis taxes' could exist in some form until 2014[…] Many foreign companies have expressed displeasure with the unpredictability of Hungary’s tax regime[...] Many critics have claimed that the taxes will have the adverse effect of reducing foreign investment and economic growth, and will offset economic benefits of recently approved cuts in personal and corporate tax rates“ (U.S.Department of State 2011).

Increased state interference in the economy including frequent and unpredictable policy changes (e.g., sectoral taxes, pension nationalization, mortgage pre-payment schemes, utility tariff cuts) have hurt the investment climate, diminishing prospects for recovery (IMF 2013). Even though the investors' reaction was portrayed as negligable, various companies have stated the opposite. “AstraZeneca Plc (AZN), the U.K.’s second-biggest drugmaker, set up its clinical research and development center in Warsaw instead of Budapest, and cut the number of clinical trials conducted in Hungary to 16 from 24 in 2010 because of the unfavorable market environment, country director Alexandra Heringh said“ (Bloomberg.com 2012). Such reactions show that investors are everything but insensitive to changes in the business environment, especially in areas as important as taxation policies.

2.6 Investment promotion laws

Most important legislation necessary for a functioning market economy was already in place by 1992-93, and law-enforcement organizations and lawyers representing firms and individuals started obtaining experience in their implementation (Kornai 1996). Today, a substantial body of laws protects foreign investment in Hungary, providing national treatment and enabling profit repatriation. The most notable legislation is the Foreign Investment Act of 1988, granting full protection to the investments and businesses of non-Hungarian resident investors, guaranteeing investors will be treated equally as national investors (Eubusiness 2009).

There are various incentives, for which interested investors are to address the Hungarian Investment and Trade Agency. Investors in the manufacturing sector can obtain non-refundable cash subsidies, based on individual government decisions. Exepmtion for 80 percent of the corporate tax for ten years following the fulfillment of the investment can be granted. Training subsidies in the form of 25-60 percent of eligible training costs are provided as a non-refundable cash subsidy. There are non-refundable cash subsidies for workshop establishment aid, as well as job creation subsidies. Social tax can be decreased for five prioritized labour groups, to either 0 or 14 percent, instead of the general 28.5 percent (Hungarian Investment and Trade Agency 2013). Besides the manufacturing sector, many of the aforementioned incentives are granted for the services sector as well.

2.7 Obstacles to FDI

The EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS) was conducted in Hungary. It is a company-level survey, based on face-to-face interviews with managers, examining the quality of the business environment. The results show tax rates and tax administration are the most severe problems, followed by access to finance and corruption, while courts represent almost no problem at all (BEEPS Hungary 2010). The 2009 Enterprise Survey, conducted by the World Bank and the International Finance Corporation, shows that tax rates, with 38.4 percent, political instability with 24.2 percent and tax administration with 14.2 percent, account for the most important issues. Labour regulations, business licences and permits and courts are not considered significant issues (Enterprise Survey Hungary 2009). László Akar, vice-president of GKI Economic Research, argues the export sector is growing strongly, based on growth in the German economy which is the

Hungary’s main market. However, he says, Hungary is lagging behind the rest of the Visegrád group (The Financial Times 2014).

Unpredictable policies implemented by the government are most certainly influencing the business climate and the investors' perceptions. It is not only issues such as taxation that influence the decisions on entering into investments or not; the whole economic policy has a direction that is either conducive to foreign investment or it is not. In 2010, Orbán's government adopted a 'national capitalism' approach, prioritizing building the national economy capable of surviving international competition, and worrying less about creating open markets, as required by the European Union (Martin 2013). Despite the 'new turn' in economic policy, recent investments show that Hungary has not turned its back to foreign investors.

Chapter 3 - Case study: Croatia

In this chapter I will analyze Croatia's economic and FDI trajectories. After that I will address the issue of its welfare state and Labour Code, describe the privatization processes, look into FDI promotion and obstacles, and touch upon recent reforms.

Croatia is heading toward its sixth consecutive year of economic contraction, with GDP estimated to fall by 0.5 percent in 2014. During the recession years, Croatia lost over 12 percent of its output as the rate of GDP contraction slowed to 1 percent in 2013, with around 0.3 percentage points due to the loss of preferential export status to the Central European Free Trade Agreement (CEFTA) region after the country’s July 2013 accession to the European Union. Public debt is estimated to rise above 64 percent of GDP, and the youth unemployment rate at over 40 percent is one of the highest in Europe (World Bank 2014). The country's economic perplexity is often considered a puzzle, whose solution is often offered via a simple explanation: the homeland war forestalled the potential development of a state which was considered one of the more advanced federal republics of the former Yugoslavia. Its economic hardship has been an intriguing question, and one of the ideas is continuously offered as a 'magical solution' is foreign direct investment.

FDI is often referred to as a panacea for a deteriorating balance of payments, the rising unemployment, GDP fall and other burning issues. Sometimes there are potential negative consequences, as well as situations when FDI brings very few benefits to the host country; for example, cases when it is more a matter of exploiting a cheap labour force. In this thesis, however, based on the positive example of Hungary, I am arguing FDI has more benefits than negative consequences.

Despite the benefits, lest one forget FDI might be a panacea for many things, but it does not substitute a sound domestic economy; it cannot be the engine of a machine that is not functional. Where one *can* establish a link is precisely in the policies, institutions and frameworks that are necessary for both domestic and foreign investment. “Other externalities are an impulse toward human capital development and the building of an institutional structure that will enable macroeconomic stability and an investor-friendly environment. This is an attractive policy that host governments should adopt regardless of FDI, but, in combination with the proper host country policy mix, the FDI presence can help speed up that process. Only the development of such stable and transparent environments can lead up to and sustain healthy domestic savings-generated growth“ (Sohinger and Harrison 2004, 68).

From the political perspective, Croatia has come a long way; from a country struggling for independence, to a member of the European Union. On the other hand, the economic perspective is quite gloomy. It is not to say there should not be strong focus on attracting FDI, however, I would argue there are two things to bare in mind. First of all, stimulating domestic investment should not be considered as less important, i.e.incentives should exist for both domestic and foreign investors. Croatia's economy today is different than the one it was in the beginning of 1990s. Despite the overall hardship, some successful enterprises *do* exist and many things are now accomplished more easily than 20 years ago, from obtaining loans to establishing businesses. Therefore, successful domestic enterprises should be provided support in expanding and conditions for establishing *more* successful businesses should be created. Secondly, the same idea ought to be a guideline when creating and implementing policies for attracting FDI. Many 'FDI-conducive policies' do not only affect FDI: *any* kind of investment requires certain preconditions, regardless whether it is a question of a domestic or a foreign one. Perhaps the urgent need for capital inflow from abroad influences the policy makers, making them focus more on policies related to attracting FDI, and less on the ones directed towards domestic investors as well. Critiques by foreign investors are also often taken more seriously than the ones by domestic investors. Yet, looking at the big picture, one could argue that a functional framework is necessary for a functioning economy, regardless of the source of investment.

3.1 Economic trajectories

As a part of Yugoslavia, Croatia practiced the model of socialist self-management: economic activity was coordinated through plans but they were not of such a binding nature and, when making decisions, enterprises had to rely on market forces (Gross and Steinher 1995). From 1952, the year with the first available post-WW2 statistical data on Croatian macroeconomic performance until 1989, marking the end of the socialist period and the beginning of transition, the Croatian economy was growing at an average annual rate of 5.2 percent (Stojčić 2012).

Transition towards a market economy formally started in 1989 with the introduction of laws permitting new private businesses and the full ownership transfer, from socially owned means of production to employees and outside owners, even though some degree of price and trade liberalisation and small entrepreneurship existed before 1989. The policies were undertaken under the conditions of war, which, alongside specific political conditions, did not facilitate the whole process (Stojčić 2012). According to William Bartlett, key problem for the transition was controlling inflation, broken linkages of industrial development with other former republics, decline of agriculture and a neglected service sector. The key policy issue was whether liberalization would be enough to achieve these objectives or whether a strong state was needed to ensure reforms were implemented (Bartlett 2003).

Bičanić and Franičević (2003) argue that, already in 1988, the main pillars of economic transformation (markets, level playing fields for private, state and socially owned enterprises) became acceptable. This was then institutionalized in the 1989 Enterprise Law and other legislation. However, by the end of 1989, Yugoslavia, including Croatia as its federal unit, was experiencing a crisis coloured by inflation and shortages. Federal Prime Minister Ante Marković's stabilization programme in 1990 was successful but short-lived. The authors describe the 'first transformation' in the form of economic changes - liberalization and privatization, and political changes – democratization and party pluralism. Those processes were missing an explicit European dimension, i.e.there was no push in the form of the prospect of an upcoming EU integration and Europeization (Bičanić and Franičević 2003).

Owing to the effects of war and breaking of the trading links with the other former Yugoslav states, GDP fell dramatically; around 22 – 25 billion $; one and a half times pre-war national income was lost. Tourism, which was a significant source of foreign exchange, had a strong collapse; the number of tourists fell from 45.8 million nights in 1990 to 6.7 million in 1991, a fall of 85 percent. The aforementioned inflation was an endemic feature of Croatia within Yugoslavia, with an average of 69 percent par annum, between 1971 and 1991. It was caused by the lax monetary policy of the Yugoslav National Bank, leading to a chronic wage-price spiral. After Marković's short-lived success in reforms, one of the first actions by the new independent state was to introduce its own currency, the Croatian dinar, and establish the Croatian National Bank. Due to buying up reserves of foreign exchange held by enterprises and by the population, in return for domestic currency, inflation jumped again: 20 percent per month in 1991, ending up with nearly 40 percent per month by November 1993 (Bartlett 2003).

Bičanić and Franičević (2003) explain that the so-called 'failed consolidation' started with the 1997 crisis, featuring an exploding trade deficit, and lasted until the 2000 parliamentary elections. It was a period of progressively deteriorating real sector developments, which ended with a recession.“While large state managed privatization (banks, pharmaceuticals, and telecom) could keep the foreign debt low, the trade balance crisis exploded in 1998 and administrative measures to curb imports reduced the immediate danger of the trade imbalance.

At the end of the period, by 2000, the Croatian economy had developed an inward looking approach and low and unrestructured foreign trade“ (Bičanić and Franičević 2003, 22).

William Bartlett (2003) points out another problem: due to the opennes of trade, the balance of payments deteriorated significantly. Imports were growing rapidly, almost doubling, from 4.5 billion $ in 1992 to 8.4 billion $ in 1998, while exports were stagnating – 4.5 billion $ in 1998, which was even less than 4.6 billion $ in 1992. According to the author, the reason why no internationally competitive economy was being created by the peculiar method of privatization (de facto nationalization), lay behind the lack of effective industrial restructuring. In 1998, the collapse of several small and medium sized commercial banks lead to a major economic crisis, which worsened in 1999. The newly elected government in 2000 decided to implement some drastic measures such as quantitative restrictions on imports of goods for personal consumption (Bartlett 2003).

Bohle and Greskovits (2012) describe Croatia's economy as one that resembles more the 'embedded neoliberal' type of capitalism. It had mobilized resources to compensate for the transformation costs of domestic firms inherited from socialism, fostering a relatively generous welfare scheme that has helped large social groups to avoid or at least slow down the decline to underclass status.

Bičanić and Franičević (2003) define the type of capitalism in Croatia as 'crony capitalism'; “[…] a capitalist economy based on cronyism, clientelism and populism, a system in which financial markets do not dominate the allocation of capital, where markets (nascent or established) provide ample opportunity for quasi-rent generation so that the rent seeking behaviour, redistributive coalitions and the protection of rents dominate agents behaviour and optimization, where weak state is hijacked and there is policy capture and in which there is, of course, a large institutional and democratic deficit“ (Bičanić and Franičević 2003, 16). This insight makes it easier to understand why the Croatian economy did (not) develop further. The prospects of a healthy growth of the economy were precluded by the aforementioned framework, and the initial set-up was then harder to correct.

After being hit by the global crisis in 2009, the government decided it was time to reverse its economic policy and it adopted the 2010 Economic Recovery Programme. As the current government came to power, it inherited the welter of the economic downturn and adopted a Structural Reform Matrix to support macroeconomic stability and recovery. Despite intents to implement numerous reforms, the economic output has continued to slow down, and the growing deficit resulted in the country entering the European Commission's Excessive Deficit Procedure in January 2014.

3.1.1 Macroeconomy

Like Hungary, Croatia was also suffering from transformational recession, with an especially high inflation, inherited from the 1980s. In 1993, it reached its peak with 1500 percent (World Bank n.d.). "The recovery of the economy started in the second half of 1993 when the government introduced a stabilisation plan[…]" (Stojčić 2012, 69). Finally the inflation rate fell to 107 percent in 1994, and continued decreasing in the following years (World Bank n.d.).

In the period of 2005-2010, unemployment in Croatia was 10 percent, with a significant rise in 2011 of 13,4 percent and 15,8 percent in 2012 (World Bank n.d.). According to Eurostat's January 2014 report, Croatia has had one of the highest increases of unemployment rates among the EU members; from 17.4 percent in 2013 to 18.8 percent in 2014 (Eurostat 2014). Concerning figures from January 2014 show youth unemployment is 49.8 percent, the third highest rate among the EU28, after Greece and Spain (Eurostat 2014). GDP had its most dramatic fall in 2009, -6.9 percent. There has been negative GDP growth ever since, with the forecasts made by international financial institutions remaining pessimistic.

Before transition, the economy in Croatia was concentrated mostly in manufacturing and services; with the decline in tourism, the service sector contracted severely. The industries with the largest share in the Croatian manufacturing came from low (food industry, 20.2 percent in 2005), medium-low (coke-petroleum and nuclear fuels, 10.9 percent in 2005) and medium-high (chemical industry, 8.1 percent in 2005) technology-intensive industries (Stojčić 2012). In 2012, IMF reported that "Croatia's far-from-perfect pre-crisis growth model has run its course. The borrow-and-invest-in-nontradables growth model did not generate significant productivity gains and did not create many jobs, questioning its sustainability given the growing external debt. Growth plummeted in 2009 and has not yet returned" (IMF 2012,15).

According to the Croatian Bureau of Statistics, the biggest export markets for Croatia in 2012 were EU countries, accounting for 58.18 percent of all exports, followed by the CEFTA countries, with 20.96 percent. The most important markets were Bosnia and Herzegovina, Austria, Italy, Germany, Serbia and Slovenia (Statistical Yearbook 2013). However, after having exited the CEFTA due to EU accession, a partial decline of exports to those markets is inevitable.

3.1.2 FDI trajectories

"Less FDI is also a sign of a lasting inwarding-looking strategy, one that has been shown to remain an inferior option by the broader developmental literature[…]" (Csaba 2005, 60). The inward-oriented economic policy that was characteristical for Croatia for most of the period before the 2008 crisis, has its consequences even today. For many years, there was little effort to design a business-friendly environment that would attract foreign investors, and the reliance on tourism as a sort of an export industry, was quite strong. The crony capitalism that developed after the privatization process, benefiting the few politically-fit tycoons, was not conducive for establishing further conditions for stimulating the domestic economy. In the aftermath of the crisis, when the consequences of the consumption-led, import-based economy became painfully obvious, there was suddenly a revelation that urgent reforms were necessary.

Foreign direct investment enterprises in Croatia are defined by a 10 percent ownership by a non-resident investor, regardless of whether the investor has an effective voice in management. Before the onset of the crisis, Croatia made relevant progress in attracting FDI, resulting in an increase in inflows from $105 million in 1995 to $6.2 billion in 2008. The flow of FDI into the country, especially after 2000 as seen in Figure 4., was driven largely by a better investment climate, economic recovery and the start of accession negotiations with the EU in 2005. The positive trend was reversed in 2008, with FDI inflows falling sharply by 42 percent in 2009, and 88 percent in 2010 respectively. Inflows picked up again in 2011, reaching $1.5 billion (Unctad investment country profile 2013).

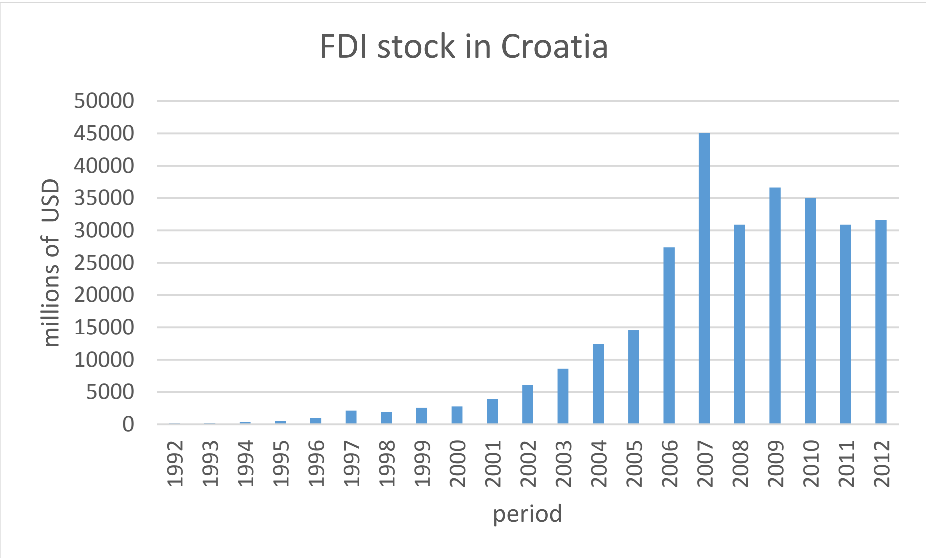

Figure 4. FDI stock in Croatia, 1992-2012, in millions of USD
Source: Author's adaptation, Unctad,
http://unctadstat.unctad.org/TableViewer/tableView.aspx

Most of Croatia's FDI came in through large-scale privatizations of SOEs, as well as through mergers and acquisitions. In the period from 1993-2002, the service sector was dominant in attracting FDI, with 27.10 percent in telecommunications and 20.35 percent in banking and other monetary intermediation (Sohinger and Harrison 2004). Due to the first round of privatization of the Croatian Telecom, there was a large investment inflow in 1999., some 1.2 billion USD. In 2000, Privredna Banka, Splitska Banka and Riječka banka were sold to foreign bank groups. In 2001, 65 percent of all investment was concentrated in three sectors: telecommunication with 24 percent, other financial intermediation with 21 percent and pharmaceutical preparations with 20 percent. Only 4 to 4.5 percent were investments in trade (Babić et.al. 2001).

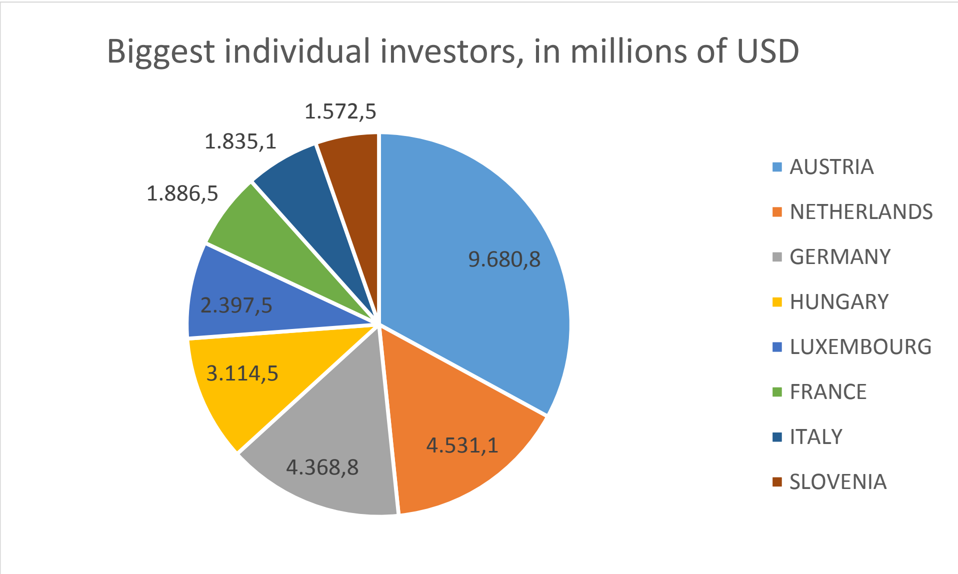

Figure 5. Biggest individual country investors, total value for period 1998-2013, in millions of USDs
Source: Author's adaptation,
Croatian National Bank, **http://www.hnb.hr/statistika/hstatistika.htm**

From 1998 until 2013, the biggest investors in Croatia were Austria (26.5 percent), The Netherlands (12.4 percent), Germany (11.9 percent), Hungary (8.5 percent), Luxembourg (6.6 percent), France (5.2 percent), Italy (5 percent) and Slovenia, with 4.3 percent of total investment, as presented in Figure 5. The high percentage for Italy and especially for Luxembourg, is due to acquisitions of Croatian banks.

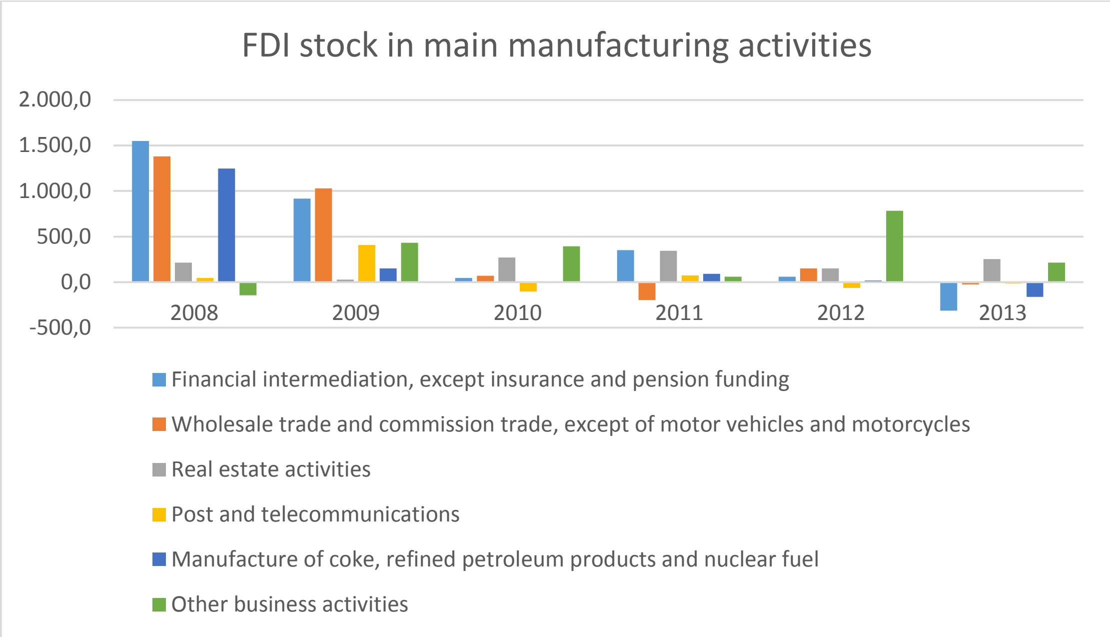

Figure 6. FDI stock in the main manufacturing activities, from 2008 until 2012, in millions of USD

Source: Author's adaptation, Croatian National Bank, **http://www.hnb.hr/statistika/hstatistika.htm**

3.1.3 Problematic exports

According to Stojčić (2012), in comparison to other centrally-planned economies, Croatian trade was initially more oriented towards the Western European markets; the main trading partners in 1989 were Italy, Germany (Federal Republic) and the Soviet Union.

> Exports are arguably the most important structural constraint of the Croatian economy. Croatian commodity exports contracted after 1990 and never recovered. Croatia's pre-transformation trade was mostly in industrial products, in 1989 Croatia was Yugoslavia's second major exporting area. The industrial sector in the early nineties simply imploded, industrial production and employment fell to minimum 49.6 percent and 73.9 percent respectively of 1989 levels, and never reached its pre-transformation levels. Industrial production and employment by 2000 was still only 63 percent and 82.4 percent respectively of 1989 levels (Bičanić and Franičević 2003, 20).

The authors state several reasons behind the contraction: it occured partly due to external reasons, partly due to the usual transformational restructuring, partly due to crony capitalism and partly due to policy options. The external reasons are seen in the loss of access to markets

- Serbia and Bosnia and Herzegovina, as well as the former COMECON area – the Soviet Union, and the collapse of tourism. A significant role in the low levels of exports is also attributed to the aforementioned crony capitalism; it is incompatible with transformation and nationalistic development visions (Bičanić and Franičević 2003). The protectionist, inward-looking policies of the HDZ had been designed to protect domestic Croatian capitalists – the so-called tycoons, resulting in a stagnation of exports (Bartlett 2003, 118).

Summarizing the previous arguments, one can observe that long-lasting consumption-led economic policy of stimulating imports placed exports at the 'back seat'; creating conditions conducive to exporting was not a part of the agenda.

3.2 Welfare state

The war was a trigger for providing a large number of refugees, war invalids and families with social benefits. In the early 1990s, enterprises started laying off workers through early retirements, thus the unemployed, along with one million pensioners, over 300 000 refugees and internally displaced persons and war invalids, were all potentially in receipt of social benefits, accounting for 40 percent of the population. In 1999, with 26 percent of GDP, the expenditure on social programmes amounted to one half of total government expenditure, the two largest items being pensions and health care. By the time the Račan government came to power, 8 percent of the population was estimated to have lived in absolute poverty – around 1,290 HRK or 100 GBP per person per month. A new pension system was built, on three 'pillars': the 'pay-as-you-go' compulsory contributions; the compulsory fully funded individual pension account, dependent on the performance of the investments held in the account; and the voluntary individual pension account (Bartlet 2003).

3.3 Labour Code

The IMF staff report states the labor market's capacity to adapt to economic conditions, employment ratio, i.e.welfare reforms and productivity enhancing investments, are important issues to tackle, in order to ensure reviving growth (Article IV, 2014). In April 2010, the government adopted an Economic Recovery Program whose central pillar is the revision of labour regulations in order to create a more dynamic labour market, by ensuring labour force flexibility and job security (European Trade Union Institute 2013).

The government had asked the World Bank for support regarding possible reforms. Firstly, a reduction of costs of hiring and firing by removing the requirement that fixed-term contracts are to be used only on an exceptional basis was suggested. Secondly, relaxing the conditions for lawful dismissal in case some individuals, or categories of protected workers, needed to be dismissed for business reasons, was advised. The Bank also advised relaxing the conditions for collective dismissal. Regarding working hours, they should be more flexible so employers could increase working hours during period of high demand or reduce them when demand is low. Wage rigidities should be addressed when they are set by collective bargaining agreements, perhaps in a way to provide for the possibility of cancelling with notice a collective agreement concluded for a definite term and by limiting the extension of an expired agreement to a maximum of six months (European Trade Union Institute 2013).

The government had "attempted to address the inefficiency of the rules concerning collective agreements […]by proposing amendments that envisaged (a) the possibility of terminating a collective agreement with one month's notice, and (b) limiting the duration of the after-effect to six months rather than the current indefinite duration" (European Trade Union Institute 2013, 2). However, it encountered fierce resistance from the side of the unions, which culminated in collecting enough signatures to call a national referendum on the question. The government then decided to withdraw the proposition of the changes.

Finally, in 2013, with the current government in power, certain amendments were made. “So far, the extension of fixed-term contracts may have lasted up to three years. Under the new law, fixed-term contract will be signed on for more than three years with clearly specified reasons. During the probationary period, the worker is not in any way protected anymore. Specifically, the employer now under the new Labour Law can fire the worker during the probe period without any foundation in the employment law – he can just state the failure of probation as a just cause for dismissal“ (Independent Balkan News Agency 2013). At the time of writing this thesis, negotiations about the amendments of the Labor Code are still taking place. There are several important amendments. First of all, introducing flexible working hours with the upper limit of 8 hours more than the present one (40 hours) and second, the possibility for small employers (up to five employees) to dismiss workers without justification. The Foreign Investors Council in Croatia has expressed hope that an agreement on the amendments will be reached, which will attract new investment, as opposed to discourage current investors and drive them out of the country (Dnevnik.hr 2014).

3.4 Privatization

In 1991, the Law on the Transformation of Socially Owned Assets was passed and in the next two years, a large percentage of companies was sold directly. The remaining shares were sold from 1994 to 1997, based on contractual sales, or were distributed to selected institutions and groups, e.g.pension and health funds, war veterans and others. By 1998, 96 percent of total capital reserved for privatisation was covered in this way (Družić 2006). “Between 1998 and 2000, half of the remaining shares were then distributed through voucher privatisation to selected social categories. Finally, in the fourth stage, after 2000, the shares in the remaining non-privatised companies and some strategic companies, mainly public utilities which were left out of the former stages of privatisation, were offered either through the stock-exchange or directly to strategic partners“ (Stojčić 2012, 68).

Priority in shares sale was given to employees (as well as former and retired ones), with discounts of 20 to 40 percent, up to a maximum of DM 20,000 worth, reaching up to 49 percent ownership in a single company. Shares could also be bought by the general public. From the total of 2,701 enterprises that submitted privatization plans, some 300-400 were rejected, and the proceeds from the shares sold, two thirds of the unsold ones and firms which failed to meet the deadline for voluntary privatization, went to the Development Fund. The other third of unsold shares went to the Pension Fund and Disability Insurance Fund. Since the Development Fund was a state agency, the enterprises were de facto taken into state ownership, with the Fund appointing managers in companies with over 20 percent of shares. That way, the state ended up with a powerful influence over economic activity and an open door to install party members into the supervisory boards. Two other specificities were debt-equity swaps between the commercial banks and the privatized enterprises, making the banks significant shareholders, and the fact that the state directly took over ownership of over 100 important large companies, including major public utilities. Privately owned fund management companies, PIFs (Privatization Investment Funds) were founded; individuals could invest their vouchers, which would then be exchanged by the PIFs, for shares held by the CPF (Bartlett 2003).

The political party in power, HDZ (Hrvatska Demokratska Zajednica, Croatian Democratic Union) had a very strong impact on all aspects of privatization. “Dynamically […] it not only captured the state as party, but served as an ideal transmission for individual and group strategies for capturing rents.[…] its commitment to liberal economic reforms was not credible at least in the following respects: efficient and fair privatization, enforcement of hard-budget constraint and levelled playing-field for all actors […] and the rule of law“ (Bičanić and Franičević 2003, 13). The idea was to give the ruling party firm control over the choice of future owners and managers, so many lucrative positions ended up in the hands of the governing party's political 'friends'. Specific groups such as war veterans, refugees and others were targeted with a voucher programme (Bohle and Greskovits 2012). When President Tuđman issued a decree in 1993, allowing the sale of enterprises owned by the newly established Croatian Privatization Fund by public tender, it opened the doors for political favouritism (Bartlett 2003).

It is precisely in such nature of privatization that many see one of reasons of the country's economic failure. Enterprises that were let to destruction could not be the tools for upgrading the economy. During its mandate, the 2000-elected coalition failed to revise as well as to reform the remaining privatization. Therefore privatization proceeded in piece-meal fashion, without any major change in methods or strategy (Bičanić and Franičević 2003).

3.5 Investment promotion laws

Foreign and domestic investors in Croatia have the same status, with equal rights and obligations. Treatment of investors is equal, regulated by the Corporations Act, Regulation on Investment Promotion and Enhancement of the Investment Environment and others laws. Incentive measures for investment projects can be found in the following forms: incentives for microenterprises, tax advantages, incentives for eligible costs of new jobs and training, incentive measures for development and innovation activities, business support activities and high added value services, incentives for capital costs of the investment project and for labour intensive investment projects. Profit tax incentives are formulated according to the value of investment, number of newly employed and the period of employment, ranging from 10 to 0 percent tax rate (Agency for Investment and Competitiveness n.d.).

Depending on the respective county's unemployment rate, employment incentives in relation to eligible costs of opening new workplaces are provided, along with an increase in grant for technology and innovation and development centres, an increase for business support strategic activities and high added value investment activities and incentives for innovation and development activities. Among others, the IMF has advised additional steps to enhance the business climate in Croatia: a swift implementation of judicial reform and further restructuring of state-owned enterprises. There has been progress but further work is necessary (Article IV 2014). “Despite recent progress, however, problems remain that dampen investment in Croatia. Amid a backlog of just under a million pending cases, even the simplest cases can take years to resolve. The difficulty of obtaining timely judicial remedy in a dispute has hindered investment in Croatia“ (Eubusiness 2009).

In October 2013, with the objective to simplify and speed up the delivery of all documentation and approvals necessary for launching any strategic or important project in Croatia, as well as to bring decision-making in regard to strategic projects to the central government level, the Croatian Parliament adopted the Act on Strategic Investment Projects. All investments given a mark of strategic investment have the right to have faster procedure; all related official procedures are urgent and have top priority. All official opinions must be rendered within 15 days, only in exceptional cases within 30 days. The competence for issuing location, construction and usage permits is completely transferred from local government units to the Ministry of Construction. Also, a location permit may be issued even if there is no urban development plan or detailed development plan (Ministry of Foreign and European Affairs 2014). According to a part of the public, the Act is controversial, requires very little conditions for the investors to be fulfilled, and establishes very loose criteria for who the investors. According to the government, it is an urgent measure. Since the Act has been brough recently, results are yet to be seen. The idea is to ensure preparations for investments to be speedily carried out. Ideally, it ought to be the case for all types of investments, be they domestic or foreign, small or large. Hence, if the efficiency of the administrative hurdles and the judiciary does not improve with time, the 'privileged' investments that fit the description of a 'strategic project' will be pushed forward, while the less privileged ones might again get caught up in the web of bureaucracy. Another problem which is addressed by the Act is the inefficiency of the local self-administration and the problems it causes the investors.

3.6 Obstacles to FDI

Already in 2001, the Croatian National Bank emphasized some of the main issues which obstruct FDI flowing to Croatia; a sluggish and highly corrupted state administration, unregulated arreal books, protracted bureaucratic procedures and slow and inefficient judiciary. The Bank also advised that the 'rules of the game' be regulated by law, in order to ensure security of investment (CNB 2001). Many of the aforementioned problems have not been fully resolved even 13 years after CNB's publication. It implies that reforms were either not conducted, or have started to be conducted fairly late. BEEPS was conducted in Croatia, in 2005 and 2008 cycles. When placed on a relative rank, from 1 to 10, the most severe problems were tax rates, courts, corruption and access to finance (BEEPS Croatia 2010). Similar results are found in the Enterprise Survey. Business owners and top managers in 360 firms were interviewed. After being presented with a list of 15 business environment obstacles, they were asked to choose the biggest one for their business. 27.9 percent stated it was tax rates, 21.9 percent access to finance, 10.6 pointed out practices of the informal sector, while 8.7 said it was political instability and 5.6 labour regulations and 4.9 percent courts (Enterprise Survey Croatia 2013).

3.7 Local self-administration inefficiency

Counties and municipalities have autonomy in executing their powers. As the Foreign Investors Council argues, a problem that is reiterated is the inefficiency of the local self-administration. Their view is that, when local governments fail to cooperate or support investors in their endeavours, they fear no sanctions, due to the fact their budget incomes partly come from the central budget, making them count on certain funds (Tportal 2014). Examples exist such the one where investors from Norway wanted to invest 250 million Euro, and the process of buying property, as well as areal plans' issues, has lasted for 5 years (Jutarnji.hr 2014).

Such occurences show that problems arise due to the lack of political will, complex bureaucratic procedures and, not seldom, hidden interests of the local political elites; investors are thus literally *driven* away. This clearly does not work in favour of presenting Croatia as a country that welcomes FDI. Another unsuccessful example is IKEA, the Swedish furniture producer, which has been setting up a business in Croatia for 16 years. Administrative barriers and an unclear division of responsibility between the state and local levels are commonly stated as obstacles (Jutarnji.hr 2012).

3.8 Reforms

The accession negotiations pushed significant reforms; many of them were not 'domestically owned' but nevertheless implemented, if the EU membership was ever going to become a reality. Csaba notes EU membership does not replace sound domestic policies, also in respect to FDI (Csaba 2005). For the case of Croatia, however, it was a most significant driver.

In 2012, for the purpose of lowering the costs of labour, health care expenditures which are payed based on the gross salary by the employers were cut down from 15 to 13 percent, in order to provide more favourable conditions for the employers. According to the Ministry of Finance (2014), those payments account for 34.5 percent of the budget income. Such a high percentage might explain the government's recent decision to bring the rate back to 15 percent (Liderpress.hr 2014). Such changes of policies do not give an impression of stability nor do they instill confidence.

In April 2014, the World Bank and Croatia signed a 150 million Euro Development Policy Loan. The loan supports reforms in two broad areas: fiscal consolidation efforts through expenditure-based adjustments in public administration, health, pensions, and social welfare areas, and the growth of the private sector by improving the business environment and reducing state involvement in the corporate sector. Some of the key expected results from the loan are reductions in: primary general government spending, general government wage bill, total public health spending, social benefit spending, pension spending; labor force participation rate (ages 15-64) increasing to 61 percent in 2014; private sector share in GDP increasing and research and development spending increasing (Ministry of Finance 2014).

The World Bank suggests reforms oriented towards stimulating the private sector. It is the type of reforms necessary for stimulating FDI as well: strengthening public administration through efficiency improvements in the governance and management of public enterprises; better market governance through improved judicial processes and better regulatory oversight of private sector activities, and red tape reforms to facilitate doing business (Country Partnership Strategy 2013). The necessity to reform the public administration and the judiciary system are clearly stated: „Often cited highly in the list of barriers to doing business in Croatia[…]. The unreasonable lengthy duration of proceedings and the slow and inefficient judicial process has been a challenge to domestic and foreign investors alike“ (Country Partnership Strategy 2013, 19).

Reforms were implemented via the Justice Sector Support Project (JSSP) and the Integrated Land Administration System Project (ILAS). The JSSP has helped in upgrading the courts' case management system, while ILAS and its predecessor project the Real Property Registration and Cadastre Project, have helped reduce the backlog in land registration by 80 percent and introduce a common land database (World Bank 2014).

Chapter 4 - Case comparison

According to the *Doing Business* rank, Hungary takes up 54.place out of 189 countries, compared to Croatia's 89. place. A similarity can be observed between the Hungarian policy-making in the period after 2004, and the Croatian one. László Csaba (2012) describes the Hungarian style as 'drifting'; there has been a lack of a coherent strategy in policy making. Such a description could be attributed to Croatian policies. Up to the global crisis period, it was a consumption-led economy: there were more investments and loans than savings. Both the government and the household sector were not accustomed to saving; the real-estate boom prompted citizens to take up loans and live above their financial capacities. There was no clear economic strategy regarding investment; one of the rare goals that was successfully fulfilled was the macroeconomic stabilization.

In this thesis, I have emphasized some elements for which I have argued are necessary for a foreign (as well as domestic) investment-conducive environment:

1. regulated judiciary and effective bureaucracy,
2. flexible labour code,
3. effective local and regional self-administration,
4. investment stimulation and
5. predictable economic policies with an emphasis on taxation policies.

I will now recapitulate the aforementioned elements in Hungary and Croatia, with the aim to structure recommendations for Croatia, based on the example of Hungary.

4.1 Regulated judiciary and effective bureaucracy

A judiciary can be improved in several different ways: higher-income economies look for ways to enhance efficiency by introducing new technology, while lower-income economies often try reducing backlogs by introducing periodic reviews to clear inactive cases from the docket and by making procedures faster. Contract enforcement in Croatia takes 572 days and requires 38 procedures. On the ease of enforcing contracts, Croatia stands on 49th place. According to *Doing Business*, in the period from 2009 until 2014, Croatia has not implemented any reforms on this matter (Economy profile Croatia 2014). In Hungary, contract enforcement takes 395 days and requires 35 procedures, with a fairly higher ranking than Croatia - it is currently on 15th place (Economy profile Hungary 2014). Measures for ensuring a faster and more effective judiciary are necessary to create an environment which will not drive investors away. It is important to create a surrounding that will send out the message that it is a country where the judiciary is not an obstacle to business.

An ineffective bureaucracy and state administration often slow down the realization of investments. For example, dealing with construction permits, which is important in case of greenfield investments, takes almost four times longer in Croatia than in Hungary, while a similarly relevant matter, registering property, takes six times longer. This is an evident example of a sluggish bureaucracy that is not conducive to any type of investment; no investor would feel encouraged to engage, knowing he would have to face such protracted procedures.

4.2 Labour code

The idea behind the 2012 amendment of the Hungaria Labour Code was to allow more flexible regulation, fostering greater competitiveness of the Hungarian economy and ensuring “one million new jobs by 2020“ (Government Programme 2010). Similar recommendations have been suggested to the Croatian authorities by various institutions such as the World Bank and the IMF. Among the most important amendments planned are introducing flexible working hours with the upper limit of 8 hours more than the present one (40 hours) and the possibility for small employers (up to 5 employees) to dismiss workers without justification.

BEEPS results for Hungary have not stated labour regulations as being an issue, while in Croatia it was listed as one of the problems (World Bank 2010). Hungary has a coverage rate of collective agreements around 23 percent, while for Croatia, the figures are estimated at 60 percent (Bagić 2010). Public administration has almost 100 percent coverage, while the wider public sector including state-owned enterprises has more than 70 percent coverage. In the private sector, coverage is estimated at 45 percent (Eurofund 2012). Such a difference in coverage may be one of the reasons behind the stronger resistance towards unfavourable amendments of the Code in Croatia, but also, a stronger reason to push for changes. Because of such a high coverage rate, labour regulations are highly defined and allotted by collective agreements, thus more flexibility is required.

4.3 Effective local and regional self-administration

The literature reveals no particular issues regarding the local administration obstructing investment in Hungary. In Croatia, however, there is the problem of inefficiency of the local self-administration. Obstructing investment occurs through protracting bureaucracy issues, such as registering property, issuing construction permits, as well as potential malversations conducted by 'local sherifs'. The Croatian Parliament adopted the Act on Strategic Investment Projects in 2013, which should ensure larger projects are carried out faster. That can resolve possible issues that larger investors have; on the other hand, in case of smaller projects, this is not a viable solution. A regulated judiciary and an effective bureaucracy should help with this. Naturally, self-administration is supposed to be independent from central government. Croatia is most certainly not the only case with such obstacles towards investors. Yet, numerous negative examples show some changes are necessary. Autonomy regarding investments cannot completely be taken away from local and regional self-administration, for it would distort the whole purpose of *self*-administration, yet, investments cannot be obstructed either. Hence, a solution in between should be implemented: reforms to make the bureaucracy faster and more effective are necessary.

4.4 Investment stimulation

In respect to investment incentives, the general principles are similar, but there are some structural differences. For cash subsidies, the Hungarian government decides on each project individually, on the condition that the investment value is at least 10 million Euro. In Croatia, capital costs of investment projects in the value of min.5 million Euro, with min.50 new jobs created, are subsidized. The cash grant is between 10 and 20 percent of the eligible costs of investment, and can be used for construction of a new factory, production facility or tourist facility, or buying of new production equipment. Tax allowances are similiar, for periods up to 10 years. There are training subsidies, as well as job creation subsidies. Hungary has a 'social tax': the rates are lower for five prioritized groups of labour. It also has workshop establishment aid, for employing at least 50 new students.

Analyzing current investment incentives, one can note there are no significant differences in the approach. Most areas are adressed in both countries. However, in order for Croatia to successfully grant incentives, other conditions defining a stable, business-friendly environment have to be fulfilled as well; investors will not only be attracted by incentives, if they cannot count on a stable environment in other respects.

4.5 Taxation

Croatia stands at the 34th place on the ease of paying taxes, while Hungary stands at 124th (Economy profile Croatia, Hungary 2014). In that respect, Croatia is therefore ranked seemingly better. Corporate tax rates are similar: 20 percent in Croatia; 10 percent up to a tax base of 500 million HUF, and 19 percent above that, in Hungary. According to BEEPS, tax rates and tax administration seem to be considered as an important obstacle in both countries

(BEEPS Hungary 2009). The Hungarian government's 'crisis taxes', implemented unanounced, were heavily criticized by the investors. Their Croatian counterparts have also been resented for similar unpredictabilities; for example, health care contributions payed by the employers, which were initially lowered from 15 to 13 percent of the gross salary in order to lower the pressure on employers and make the labour cost more competitive, rose again to 15 percent.

BEEPS and Enterprise Surveys show corporate tax rates and administration are considered obstacles in doing business. However, some other data imply tax rates are not such a relevant obstacle anymore. Among 28 European countries, in 2011, the ones with the highest volume of FDI had tax rates of 25 percent and above, while the mean tax rate was 22.6 percent (author's calculation, Quantitative Analysis paper 2013). Croatia, with its 20 percent, did not stand out significantly. What seems to matter more than the rates are the inconsistet tax policies, i.e.unplanned introducing new taxes.

Conclusion

By comparing cases of Hungary and Croatia based on the extant literature, policy recommendations of international institutions and professional associations, and surveys with investors and enterprises, this thesis has synthetised policy recommendations for creating an FDI-friendly environment in a post-transition country. I have summarized certain conditions which are necessary for building an investment-conducive environment.

Out of the five elements compared, I have shown Hungary is better ranked in three areas: regulated judiciary and effective bureaucracy, flexible labour code and effective local and regional self-administration. Unpredictable taxation policies, as well as tax rates, are not considered favourable in neither of the cases, while investment incentives are designed in a similar framework in both countries. I confirm the recommendations that flexibilisation of the Labour Code is necessary. The judiciary, bureaucracy and the local self-administration have also not been negatively assessed in the case of Hungary. Hence, reforms in those areas are also necessary in Croatia. It is advised for taxes and levies in both countries not to be introduced *ad hoc*. I argue investment incentives are not the key to attracting FDI. A reliable environment must exist first, in order for the incentives to have a full effect.

My findings are in line with Bohle and Greskovits's (2012) arguments about the weakness of the Croatian state, the hindering effect of the war and, most importantly, the lack of active engagement in FDI-conducive policies. I also confirm Bičanić and Franičević's (2003) contention that an inward-looking strategy was applied, which, along with 'crony capitalism', has lead to low FDI and low export levels. My arugment conforms with László Csaba's (2009) view that the inward-oriented, 'do-it-yourself' strategy does not attract FDI and stimulate export growth. Csaba explains it quite manifestly: “On the quantitative plane we do not find any single case where the sufficiently high rate of export growth could have been secured without reliance on FDI in the strategic sectors" (Csaba, in: Winiecki 2009, 169). My findings on Hungary also confirm arguments of the other authors of Winiecki's (2009) *Competitiveness of New Europe*, which show an interrelation between FDI, the significant role of MNCs and export growth. Based on this, I justify the necessity of the aforementioned policy reforms for Croatia.

The analyses and evidence show that, for small, open economies, attracting FDI means boosting economic (and export) growth. The thesis derives recommendations for FDI-conducive policy reforms for Croatia. The findings can possibly be applied to other post-transition countries, perhaps other countries of the former Yugoslavia, which are also on the path towards EU integration.

Reference list

Babić, Ante, Pufnik, Andreja, Stučka, Tihomir, *Theory and reality of foreign direct investment in the world and in transition countries; A review of Croatia*, Croatian National Bank publication, 2001, http://www.hnb.hr/publikac/pregledi/p-009.htm, last acessed 04 May 2014

Bakos, Gabor, *Privatizing and liberalizing electricity, the case of Hungary*, Energy Policy, Vol.29, No.13, November 2001: 1119‑1132

Bandelj, Nina, *How EU Integration and Legacies Mattered for Foreign Direct Investment into Central and Eastern Europe*, Europe-Asia Studies, Vol. 62, No. 3, May 2010: 481–501

Bartlett, David, Selenyi, Anna, *The political enforcement of liberalism: bargaining, institutions and auto multinationals in Hungary*, International Studies Quarterly, No.42, 1998: 319-338

Bartlett, William, *Croatia: between Europe and the Balkans*, Routledge, 2003

Bellak, Christian, Leibrecht, Markus, Liebensteiner, Mario, *Attracting foreign direct investment: the public policy scope for South East European countries*, Eastern Journal of European Studies, Volume 1, Issue 2, December 2010: 37-53

Benczes, Istvan, *Market reform and fiscal policy in Communist and Post-Communist Hungary*, International Journal of Emerging Markets, vol.6.no.2, 2011: 118-131

Bičanić, Ivo, Franičević, Vojimir, *Understanding reform: the case of Croatia*, The wiiw Balkan observatory papers, 2003,

http://balkan-observatory.net/wp/2003%2011%20wiiw%20bo%20wp%20033.pdf, last accessed 30 May 2014

Csaba, László,

And the first shall be the last, Hungarian Studies, vol.25, No.2, 2011: 235-248

Hungary: The Janus-faced success story of transition, Oxford University Press, 2012

Privatization, liberalization and destruction: Recreating the market in Central and Eastern Europe, Dartmouth Publishing Company Limited, 1994

The new political economy of Emerging Europe, Akademiai Kiado, Budapest, 2005

Denisova, Irina, et.al., *Everyone hates privatization but why? Survey evidence from 28 post-communist countries*, Journal of Comparative Economics, vol.40.no.1., 2012: 44-61

Družić, Ivo, *A journey through transition time with special reference to Croatia*, Zagreb, Politička Kultura, 2006

Farkas, Péter, *The effect of foreign direct investment on research, development and innovation in Hungary*, Institute for World Economics, Hungarian Academy of Sciences, Working papers, No.81, July 1997

Filatotchev, Igor, Wright, Mike, Uhlenbruck, Klaus, Tihanyi, László, Hoskisson E.Robert, *Governance, organizational capabilities, and restructuring in transitional economies*, Journal of World Business, Vol.38, No.4, November 2003: 331-347

Greskovits, Béla, Bohle, Dorothee, *Capitalist diversity on Europe's periphery*, New York, Cornell University Press, 2012

Genc, Ela, *The abyss of foreign direct investment in Croatia*, Final Paper for Quantitative Analysis course at Central European University, 2013

Gros, Daniel, Steinherr, Alfred,

Economic Transition in Central and Eastern Europe: Planting the seeds, Cambridge University Press, 2004

Winds of Change, Economic Transition in Central and Eastern Europe, London and New York, Longman, 1995

Kornai, János

Transformational recession: The main causes, Journal of Comparative Economics, Vol.19, no.1, 1994: 37-52

Paying the bill for goulash communism: Hungarian development and macro stabilization in a political-economy perspective, Social Research, Vol.63, No.4, 1996: 943-1040

Marer, Paul, Mabert, Vincent, *The Story of GE in Hungary: A Clash of Cultures?*, Beyond Transition, The World Bank, Vol.8, No.1, February 1997, http://web.worldbank.org/WBSITE/EXTERNAL/NEWSLETTERS/EXTTRANSITION/EXTDECBEYTRANEWLET/0,,contentMDK:20691185~menuPK:1544646~pagePK:64168445~piPK:64168309~theSitePK:1542353,00.html, last accessed 15 May 2014

Mihályi, Peter

FDI in Hungary: The Post-Communist Privatization Story Reconsidered, Working Papers, Central European University, Department of Economics, Budapest, 2000

The causes of slow growth in Hungary during the Post-Communist transformation period, Institute for economics, Research centre for economic and regional studies, Hungarian Academy of Sciences Budapest, 2012

Moran, Theodor H., *Foreign Direct Investment and Development. The New Policy Agenda for Developing Countries and Economies in Transition*, Washington, DC, Institute for International Economics, 1998

Myant, Martin, Drahokupil, Jan, *Transition economies: Political economy in Russia, Eastern Europe and Central Asia*, John Wiley and sons, Inc., 2011

Roderick, Martin, *Constructing capitalisms: transforming business systems in Central and Eastern Europe*, Oxford University Press, 2013

Schöllmann, Wilhelm, *Foreign participation in privatization: what does it mean? Empirical evidence from the Czech Republic, Hungary and Poland*, Post-Communist Economies, Vol.13, No.3, 2001: 373-388

Shafer, D. Michael, *Winners and Losers. How Sectors Shape the Developmental Prospects of States*, Ithaca, Cornell University Press, 1994

Sohinger, Jasminka, Harrison W., Glenn, *The implications of foreign direct investment for development in transition countries: Challenges for the Croatian economy*, Eastern European

Economics, Vol.42, No.1, Jan-Feb 2004, http://www.jstor.org/stable/4380368, last accessed 14 May 2014

Stojčić, Nebojša, *Two decades of Croatian transition: A retrospective analysis*, South East European Journal of Economics & Business, November 2012: 63-76

Tóth, András, *The Hungarian crisis: an Austrian school explanation*, Annals of the University of Oradea, Economic Science Series, 2013: 175-182

Van Evera, Stephen, *Guide to Methods for Students of Political Science*, Cornell University Press, 1997

Winiecki, Jan ed., *Competitiveness of new Europe*, Routledge, New York, 2009

Other sources

Agency for Investments and Competitiveness,

http://www.aik-invest.hr/en/incentives/incentive-measures-for-investment-projects/,

last accessed 05 May

Central Bank of Hungary, *Stock of FDI by countries*,

http://english.mnb.hu/Statisztika/data-and-information/mnben_statisztikai_idosorok/mnben_elv_external_trade/mnben_kozetlen_tokebef, last accessed 18 May 2014

Croatian Bureau of Statistics, *Statistical Yearbook 2013*,

http://www.dzs.hr/Hrv_Eng/ljetopis/2013/sljh2013.pdf

Croatian National Bank,

Foreign Direct Investment Statistics, http://www.hnb.hr/statistika/hstatistika.htm

Doing Business,

Economy Profile: Croatia, 2014,

http://www.doingbusiness.org/data/exploreeconomies/~/media/giawb/doing%20business/documents/profiles/country/HRV.pdf?ver=2

Economy Profile: Hungary, 2014,

http://www.doingbusiness.org/data/exploreeconomies/hungary/~/media/giawb/doing%20business/documents/profiles/country/HUN.pdf

EBRD-World Bank Business Environment and Enterprise Performance Survey Croatia (BEEPS),

BEEPS at a glance 2008, January 2010,

http://siteresources.worldbank.org/INTECAREGTOPANTCOR/Resources/704589-1267561320871/Croatia_2010.pdf

http://siteresources.worldbank.org/INTECAREGTOPANTCOR/Resources/704589-1267561320871/Hungary_2010.pdf

Eubusiness.com,

http://www.eubusiness.com/europe/hungary/invest/, last accessed 11 April 2014

http://www.eubusiness.com/europe/croatia/invest/, last accessed 11 April 2014

European Fundation for the Improvement of Living and Working Conditions (Eironline),

Croatia: Industrial relations profile, 2012,

http://www.eurofound.europa.eu/eiro/country/croatia_4.htm

Hungary: Industrial relations profile, 2012,

http://www.eurofound.europa.eu/eiro/country/hungary.htm

http://www.eurofound.europa.eu/eiro/2012/11/articles/hu1211011i.htm,

last accessed 10 April 2014

European Trade Union Institute, Clauwaert, S., Schömann, I., *The crisis and national labour law reforms: a mapping exercise. Country report: Croatia, 2013*, http://www.etui.org/Publications2/Working-Papers/The-crisis-and-national-labour-law-reforms-a-mapping-exercise, last accessed 14 May 2014

Eurostat, Newsrelease euroindicators, February 2014,

http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/3-28022014-AP/EN/3-28022014-AP-EN.PDF

Hungarian government,

http://www.kormany.hu/en/prime-minister-s-office/news/lego-plant-inaugurated, last accessed 24 May 2014

http://www.kormany.hu/en/prime-minister-s-office/news/procter-gamble-to-invest-19-billion-forints-in-hungary, last accessed 24 May 2014

Government Programme 2010 (Nemzeti Megújulás Programja),

p.18, www.kormany.hu, n.d.

Hungarian Investment and Trade Agency,

http://www.hita.hu/Content.aspx?ContentID=220482e5-5231-4d5f-bf8a-bbe11268d14a,

June 2013, last accessed 26 May 2014

International Monetary Fund,

Country report Croatia No.12/302, November 2012, https://www.imf.org/external/pubs/ft/scr/2012/cr12302.pdf

Country Report Hungary No.13/85, MArch 2013, http://www.imf.org/external/pubs/ft/scr/2013/cr1385.pdf

Ministry of Finance, *Amendments to the Republic of Croatia State Budget for 2014*,

World Bank and Croatia sign agreement boosting economic recovery, http://www.mfin.hr/en/novosti/world-bank-and-croatia-sign-agreement-boosting-economic-recovery, last accessed 04 May 2014

Yearly Report for 2012, February 2014,

http://www.mfin.hr/adminmax/docs/GODISNJAK%202012.pdf,

last accessed 04 May 2014

Organization for Economic Cooperation and Development,

Foreign Direct Investment for Development: Maximizing Benefits, Minimizing Costs, 2002,

http://www.oecd.org/investment/investmentfordevelopment/1959815.pdf

FDI positions by industry,

OECD Benchmark Definition of Foreign Direct Investment, Fourth Edition, 2008, http://www.oecd.org/daf/inv/investmentstatisticsandanalysis/40193734.pdf

United Nations Conference on Trade and Development,

http://unctad.org/en/Pages/DIAE/Foreign-Direct-Investment-(FDI).aspx,

last accessed 23 May 2014

Foreign direct investment per country,

http://unctadstat.unctad.org/TableViewer/tableView.aspx

Investment country profiles: Croatia, February 2013,

http://unctad.org/en/PublicationsLibrary/webdiaeia2012d12_en.pdf

Transnational corporations, Vol.10, No.3, 2001

U.S.Department of State,

http://www.state.gov/e/eb/rls/othr/ics/2011/157292.htm, last accessed 11 April 2014

World Bank,

International Bank for Reconstruction and Development and International Finance Corporation and Multilateral Investment Guarantee Agency: Country Partnership Strategy for the Republic of Croatia for the period FY14-FY17, 27 June 2013, http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2013/06/07/000356161_20130607115835/Rendered/PDF/776300CAS0P143020Box377322B00OUO090.pdf

World Bank Group Croatia Partnership, *Country program snapshot*, April 2014, http://www.worldbank.org/content/dam/Worldbank/document/eca/Croatia-Snapshot.pdf

World Bank Enterprise Survey Croatia 2013,

http://www.enterprisesurveys.org/Data/ExploreEconomies/2013/croatia,

last accessed 24 May 2014

World Bank Enterprise Survey Hungary 2009,

http://www.enterprisesurveys.org/Data/ExploreEconomies/2009/hungary

last accessed 24 May 2014

http://data.worldbank.org/indicator/SL.UEM.TOTL.ZS?page=1&order=wbapi_data_value_1991%20wbapi_data_value%20wbapi_data_value-first&sort=asc, last accessed 17 May 2014

Articles

Bloomberg.com,

http://www.bloomberg.com/news/2012-07-24/Orbán-s-tax-binge-repels-investors-as-recession-menaces-hungary.html, last accessed 26 April 2014

Budapesttimes.hu,

http://budapesttimes.hu/2011/04/27/comeback-of-a-traditional-bus-company/,

last accessed 29 April 2014

Dnevnik.hr,

http://dnevnik.hr/vijesti/gospodarstvo/strani-ulagaci-nadamo-se-da-nas-rasprava-o-zor-u-nece-otjerati-iz-hrvatske---325116.html, last accessed 10 April 2014

Independent Balkan News Agency,

http://www.balkaneu.com/labor-legislation-croatia/), last accessed 10 April 2014

Jutarnji.hr,

http://www.jutarnji.hr/investitori-bjeze--propale-su-sve-strane-investicije-u-hrvatsku-/1060647/, last accessed 08 May 2014

http://www.jutarnji.hr/medunarodni-skandal-sa-zemljistem-na-hvaru-otkrivamo-kako-lokalni-mocnici-varaju-ulagace/1187183/, last accessed 08 May 2014

Liderpress.hr,

http://liderpress.hr/tvrtke-i-trzista/poslovna-scena/zbrka-s-obracunom-nove-stope-doprinosa-za-zdravstvo/, last accessed 04 May 2014

The Financial Times,

http://www.ft.com/intl/cms/s/0/9b9aa140-b59d-11e3-a1bd-00144feabdc0.html#axzz301TqaPsu, last accessed 26 April 2014

Tportal.hr,

http://www.tportal.hr/vijesti/biznis/328829/Velike-zemlje-nece-Hrvatskoj-dopustiti-porezne-vratolomije.html, last accessed 07 May 2014