AMCHAM HUNGARY POSITION BRIEF No. 1

ENCOURAGING FOREIGN DIRECT INVESTMENT IN HUNGARY

JUNE, 2003

This AmCham Position Brief is the first of a series of short position papers designed to identify possible improvements, which may provide immediate and sustainable benefits to the Hungarian economy.

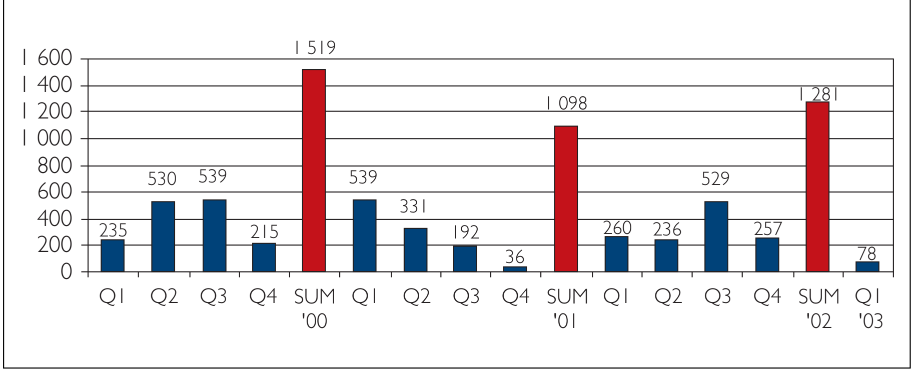
The American Chamber of Commerce in Hungary submits this particular Position Brief in the hope that it will encourage decision makers in Hungary to take action to dramatically improve the climate for business investment in Hungary. AmCham believes that sponsoring FDI proactively is a necessary prerequisite for economic growth and improvement in competitiveness.

The recent stagnation in FDI reflects deterioration in the competitiveness of the Hungarian economy relative to neighboring countries. A prolonged stagnation in FDI will also hinder the necessary investment to sustain and grow Hungary's competitiveness.

…"to take action to dramatically improve the climate for business investment in Hungary"…

Foreign Direct Investment (FDI[1]) in Hungary has languished in the past years, as Graph 1 below indicates.

Graph 1



FDI inflows to Hungary in 2000–2002 (in EUR million)

Source: National Bank of Hungary

[1] *In this Paper, FDI figures for Hungary will always refer to equity only.*

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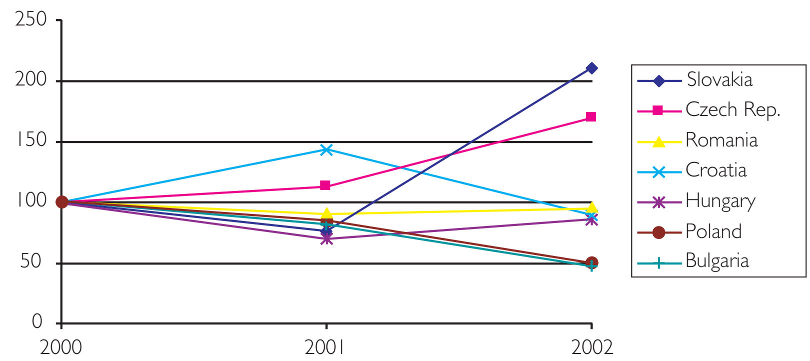
It is also noteworthy that the arrival of major new investors to Hungary is an increasingly rare event, with neighboring countries winning an even larger share of the new entries.

As indicated by the graph below, in 2002 the big winners in Central Europe with respect to FDI inflows were Slovakia and the Czech Republic:[2]

Graph 2



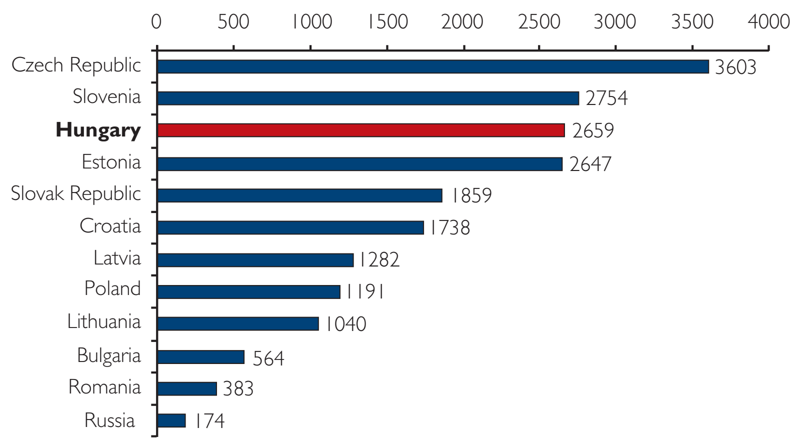
Change of FDI inflow in seleected CEE countries between 2000–2002 (2000=100 percent)

Source: National Banks

...“we propose Hungary should be more proactive in encouraging FDI as well as improving the institutional framework of receiving FDI”...

As the following graph demonstrates, Hungary is now lagging behind other Central European countries in attracting FDI on per capita basis:

Graph 3



Estimated FDI stock per capita in Central and Eastern Europe by end of 2002 (in USD)

Source: The Vienna Institute for International Economic Studies

Recognizing that the mission of AmCham includes the objective of “promoting the global competitiveness of Hungary” – we propose Hungary should be more proactive in encouraging FDI as well as improving the institutional framework of receiving FDI. In our view, a successful program for promoting FDI must possess the following four elements:

1. There must be bona fide benefits for investors.
2. In order to influence corporate decision-making the benefits must be certain and predictable at the time that investment decisions are made and must be sustainable.
3. These benefits must be clearly communicated to the investment community.
4. There must be an efficient, influential institution to welcome foreign investors, answer their questions, assist the gathering of information and coordinate the approval of incentives. International experience has shown that countries most effective in attracting FDI have a system of “one stop shopping”.

[2] It should be pointed out that Hungary took a significant lead with respect to FDI in the mid-1990’s, thanks to privatization revenues. In 2002, FDI in Czech Republic and Slovakia was enhanced by increased privatization revenues. Nevertheless, Hungary should seek to maintain FDI momentum.

Let us examine the recent Hungarian experience, including the "Smart Hungary" program, in terms of how they meet the four criteria defined above.

1. Bona fide benefits to investors

Total benefits of the Smart Hungary program are perceived to be considerably less than benefits received by investors in neighboring countries, such as Slovakia or Czech Republic, where a ten year corporate tax holiday is still advertised to investors.

In addition, the eligibility conditions for development tax credits are restrictive and difficult to comply with. This clearly puts Hungary into an unfavorable position in the competition for FDI.

By way of example AmCham presented the Hungarian Government with a recommendation to phase the general corporate taxation rate from 18% to 12% [please refer to http://www.amcham.hu/documents/TaxPaper.pdf]. AmCham advocates phasing in this decrease over three years (e.g. by reducing the tax rate two percent per annum). This low tax rate has major advantages:

A. It is simple and universal, and therefore easy to communicate. It positions Hungary uniquely in the region
B. It directly impacts the bottom line of investors
C. It impacts all investors, not just the major corporations who have the resources to apply for grants, at a time when the trend is towards smaller investors
D. The investor knows his bottom line before making the investment decision
E. It is in conformity with EU guidelines
F. The likely effect will be to significantly spur investment in Hungary
G. Elasticity effects and phasing the benefit over three years are likely to minimize the budgetary impact of this benefit

..."A potential investor in Hungary seeks certainty, predictability and sustainability of benefits before he/she makes an investment decision"...

We understand that the Government of Slovakia is planning to decrease its corporate tax rate from the current 25% to 20% or 18%. This would eliminate the single remaining major advantage of Hungary in existing investment incentives over Slovakia, which country is already competing very successfully in attracting FDI (as witnessed by the recent PSA automotive investment).

A summary of benefits available to investors under the Smart Hungary program – according to our understanding – set out in Annex A.

2. Predictability or certainty of benefits

In Hungary, an investor must apply or tender under various programs to obtain funding. A potential investor in Hungary seeks certainty, predictability and sustainability of benefits before he/she makes an investment decision. However the decision cycle of where to locate a plant can often be considerably faster than the decision cycle of Hungarian Government bodies to grant subsidies. Hence, rather than influencing the decision "which country should the investment go?" - it is often necessary for investors to first make the decision to locate in Hungary, and subsequently gather whatever grants and subsidies possible, treating such grants and subsidies as "icing on the cake." Hence, the lateness and uncertainty surrounding the incentives greatly diminishes the effectiveness of the funding in achieving their objective (of attracting investment to Hungary that otherwise would not have located in Hungary). The problem of lateness is further aggravated by the fact that several ministries overspend their budgets (e.g. subsidies granted in 2002 are funded under the 2003 budget), further adding to delays.

3. Clear communication of the benefits

AmCham is not aware of any publicly available brochure that comprehensively describes the Smart Hungary program, or why an investor should invest in Hungary in a manner that would be convincing to investors. There is a Hungarian summary of the Smart Hungary program available at the website of the Ministry of Economy and Transport (http://www.gkm.hu/site/fomenu/gazdasag/smart_hungary_021016.htm).

The best website in the region for the attraction of FDI is the website of CzechInvest, the Czech Investment Promotion Agency (www.czechinvest.com). This website contains clear, detailed information on all available incentives and provides manuals on how such incentives can be applied for. In addition, the website provides databases of industrial properties, educational facilities and suppliers. The website offers information on key industrial and service sectors and on various regions in the Czech Republic. Together with a wide range of downloadable data, statistics, publications and presentations, the above functionalities allow the investor to make a good first assessment of the investment conditions in the Czech Republic with ease and at no cost.

4. An efficient institution for receiving foreign investment

The institutional framework for dealing with foreign investors in Hungary is highly fragmented. For example, the location of a large plant in Hungary may involve decisions by the following institutions:

a) Prime Minister's Office

b) Ministry of Economy and Transport

c) Ministry of Labor

d) Ministry of Education

e) Ministry of Informatics and Communications

f) Ministry of Environment and Water

g) Ministry of Agriculture and Regional Development

h) Ministry of Finance (with respect to budgetary aspects)

i) Regional development councils

j) ITDH (only as facilitator)

k) Local Municipality

An increasing number of countries are implementing "one stop shopping" for foreign investors, where one interlocutor guides them through the entire investment process. For example, CzechInvest is such a one stop shopping institution, with power to compel decisions from other government agencies, bodies and ministries within prescribed time horizons. Other countries which have one stop shopping include Bulgaria, South Africa, Tunisia and Algeria.

While each Hungarian Ministry or agency has its own interests and agenda to protect, in this increasingly competitive race for fresh investment, the customer (e.g. investor) is key, and the relationship with each investor must be carefully and professionally managed to yield best results. This is next to impossible to achieve in Hungary through such a multitude of interfaces.

AmCham perceives that there is a critical need for adequately trained case officers, who are able to convincingly present the benefits of investing in Hungary to high-level foreign investors. This becomes all the more critical when linked with a lack of printed brochures and a complex program fragmented among multiple ministries.

Summary of main recommended action points:

- Create a simplified and powerful system of sustainable incentives to attract foreign investors. AmCham believes that a phased reduction of corporate taxes from 18% to 12% is the single most powerful incentive to promote investment in Hungary.
- The incentive program should be structured to be at least as advantageous as the programs offered in Slovakia or the Czech Republic.
- Create a clear marketing and communications program, including a new and improved website and brochures.
- The positioning adopted by Hungary in this communication program should be consistent with the development of Hungary as a regional center.
- Create a "one stop" agency to promote foreign investment, with powers to compel other government agencies and bodies.