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# Western Business in Hungary: Challenges and Ways of Coping

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# Western Business in Hungary: Challenges and Ways of Coping

J. Leslie Jankovich\*

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## I. INTRODUCTION

Over the last few years unprecedented changes have occurred in Hungary and the rest of Central and Eastern Europe and many more changes are certain to come. These changes create unique opportunities for U.S. firms that are willing to deal with challenges different from those in their domestic environment. Such opportunities can be met with thoughtfully shaped strategies designed to reap substantial benefits while keeping risks within acceptable limits. In such a dynamic situation, success calls for business readiness: an ability to change with, or better yet, in anticipation of emerging conditions.

U.S. businesses can better cope with the situation if they understand the underlying causes and forces of the emerging changes. The purpose of this article is to help the transnational practitioner better advise the corporate client on such issues as whether doing business in Hungary is right for the corporation, and if so, in what form; what are the promising opportunities and likely perils; and ways and means of optimizing reward versus risk, required resources, and time scales. Towards this end, this article provides a summary review of key factors that are relevant to Western, especially U.S., business interests in Hungary.

Additionally, this article aims to assist the practitioner to better understand these factors and develop an effective approach to sorting them out. This implies recognizing some of the forces shaping the environment, understanding the way they create opportunities and risks, and learning practical approaches to dealing with them. Further, this article describes alternative forms of business involvement in Hungary and discusses relevant opportunities and risks. Finally, a strategy is provided which outlines a potentially rewarding sequence of steps for a Western firm to utilize in the formulation of a plan for involvement in Hungary in a way that complements the firm's U.S. and global strategies and is commensurate with its risk profile.

The importance of this subject to the United States is twofold. According to the U.S. ambassador to Hungary, the U.S. government is concerned with recognizing millions of Hungarian immigrants, their families, and the significance of their contributions to the development of science, technology, and the arts.<sup>1</sup> Further, in a broader international perspective, Hungary is important to the United States as the country playing the vanguard role in the transformation of Central and Eastern Europe and is viewed as the precursor of changes throughout the region.<sup>2</sup>

It should be noted that this article covers a broader and more comprehensive view than strictly legal issues. It is not to be regarded as the authoritative source of advice with regard to specific laws in Hungary. It is based on government

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1. Charles Thomas, Address Before the Fulbright Scholars in Budapest, Hungary (Sept. 2-3, 1992) (address by the U.S. ambassador to Hungary).

2. *Id.*

documents, Hungarian and Western publications, personal discussions with officials, practitioners and scholars of law, other professionals and personal observations while in Hungary, together with research on strategy and transnational business.

## II. FORCES SHAPING THE BUSINESS ENVIRONMENT

Enterprises typically go abroad to access markets or resources on terms more favorable than those available domestically. These opportunities abroad arise from supply and demand differentials among countries. The differentials reflect varying levels of endowments of tangible and intangible resources on one hand, and needs, wants, and aspirations on the other. The essence of creating economic value and securing a share of it as profit for the venture is to transfer resources from places of abundant supply to areas where they are in shortage, thus obtaining a higher return.

The opportunities actually available to a business also reflect intervention by both domestic and foreign governments through laws, trade, and investment regulations, which modify the relative significance of supply and demand. Whether the result is an opportunity sufficiently attractive for a firm to act upon depends on the judgment of corporate decision makers in view of their corporation's strategy and risk profile.<sup>3</sup>

Conducting business effectively in a host country with conditions quite different from those found domestically requires heavy initial investment, especially of precious intangibles such as executive time and effort. Such investment can be warranted only on the basis of a substantial return. This develops only over a long period of time during which conditions favorable to the venture can be expected to prevail with a sufficiently high level of probability. Therefore, business is justifiably concerned with the predictability of relevant factors in any host country.<sup>4</sup>

The opportunities in Hungary come from the major political and economic changes of the last few years: transition from Communist totalitarianism to democracy, and from central planning to a market economy. Such transition is historically unprecedented, involving a great deal of uncertainty and warranting a careful assessment of related opportunities and risks. Thus the analysis will examine the forces—political, international, economic, and social—that affect present and probable future conditions for U.S. business in Hungary.

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3. STEFAN H. ROBOCK & KENNETH SIMMONDS, *INTERNATIONAL BUSINESS AND MULTINATIONAL ENTERPRISES* 50-58 (4th ed. 1989).

4. JOHN D. DANIELS & LEE H. RADEBAUGH, *INTERNATIONAL BUSINESS: ENVIRONMENTS AND OPERATIONS* 350-51 (6th ed. 1994).

A. *Political Forces*

1. *Relevance to Business*

The way business can be conducted is profoundly affected by the country's political system, the purpose of which is to integrate the society into a viable, functioning unit.<sup>5</sup> Many of the political forces with which business must cope have their sources in ideology, nationalism, ethnic or racial tensions, unstable governments, interference by foreign governments, international organizations, and possibly the foreign-based firm itself.<sup>6</sup> The ultimate test of any political system is its ability to hold a society together in spite of pressures from divergent ethnic, racial, and other forces. This is a major challenge in the 1990s in Central and Eastern Europe and the former Soviet Union.<sup>7</sup>

2. *Historical Considerations*

Hungary's 1100-year history is characterized by lack of continuity, transformations, and changes in values.<sup>8</sup> The historical roots of the present situation can be assessed from at least four viewpoints: international background, economic development, social history, and the institutional and political framework.

a. *International Context*

The history of the state and the history of the people are not exactly the same. There are ten million Hungarians in Hungary, three million in the neighboring countries, and some two million elsewhere—mostly in the United States.<sup>9</sup> The history of Hungarian ethnicity starts at the meeting points of Europe and Asia as early as 3000 B.C.<sup>10</sup> By the ninth century after Christ, immigration into the Carpathian Basin positioned the Hungarians between the influence of the Romans to the west and the Slavic peoples in the east. According to a widely accepted view,<sup>11</sup> the foundation and survival of the Hungarian state would not have been possible without Christianity. In this position, the country has served as Europe's

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5. *Id.* at 45.

6. DONALD A. BALL & WENDELL H. MCCULLOCH, JR., *INTERNATIONAL BUSINESS: INTRODUCTION AND ESSENTIALS* 310 (3rd ed. 1988).

7. DANIELS & RADEBAUGH, *supra* note 4, at 46.

8. Attila P6k, Address Before the Fulbright Scholars in Budapest, Hungary (Sept. 2, 1992) (address by member of the Institute of History, Hungarian Academy of Sciences).

9. *Id.*

10. *Id.* Related ethnicity appeared soon thereafter in the Carpathian Basin and continued ever since, as shown—among others. IDA BOBULA, *ORIGIN OF THE HUNGARIAN NATION* 11-15, 46, 53-56 (1982).

11. P6k, *supra* note 8.

bastion, absorbing the brunt of the onslaughts coming from the east over most of the past millennium.

For the first half of the millennium, Hungary was an important power of the times, particularly during the fourteenth and fifteenth centuries. It was in this period that the Hungarian king initiated cooperation with the neighboring Czech and Polish states as a means of supporting their independence between East and West.<sup>12</sup>

The outcome of World War I was a tragedy of truly historic proportions. Hungary lost two-thirds of its territory and a major portion of its population to the successor states.<sup>13</sup> World War II and its aftermath was a similarly shattering experience for the Hungarians.<sup>14</sup> Hungary suffered the presence of foreign troops on its soil for 500 years, aside from a brief interval between World War I and II. This presence ended only as recently as 1991.

### *b. Economic Development*

Hungary is a small country, whether measured in terms of area or population. Its economy is now characterized by medium-level development, a fact which is noticeable in such features as infrastructure, service quality, and significance with

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12. The concept, called "Visegrad Triangle," after the Hungarian city where the pact was signed, was resurrected on the pact's 625th anniversary by Hungary's then prime minister, József Antall.

13. Hungary did not start or cause the war, nor did it possess any territorial or other ambitions to be served by the war; its prime minister was the only one among the Monarchy's leaders who from the first day of the crisis consistently opposed the war. At the end, no foreign troops were on Hungarian soil. Yet, of all war's participants, she was the state most brutally punished, despite the fact that such punishment was in flagrant violation of President Woodrow Wilson's 14-point declaration. The Czechs, who like Hungarians had fought on Austria's side, received the entire northern part of Hungary, while the lion's share of the spoils was given to Romania. The Trianon Treaty of June 4, 1920 left Hungary with an area of 92,833 square kilometers (35,912 square miles, about the size of Indiana), or 28.5% of her former territory, and with 7,606,871 inhabitants, or 36.4% of her former population. Significantly, the U.S. Congress refused to recognize and sign the Treaty of Trianon. In fact, America, in order to signify its disapproval more markedly, concluded a separate peace with Hungary on August 29, 1920. ALBERT WASS DE CZEGE, *OUR HUNGARIAN HERITAGE* 11-12 (1975); SÁNDOR KOSTYA, *PAN-SLAVISM* 109-14 (1981).

14. WASS DE CZEGE, *supra* note 13, at 12; KOSTYA, *supra* note 13, at 113-14. Dispossessed of their rights, restricted in their use of their own language, abused and humiliated, the Hungarians in Romania, Czechoslovakia, and Yugoslavia turned in vain for protection of the League of Nations and those Western Powers which had guaranteed the "rights of the minorities" in the peace treaties. Only Italy and Germany sympathized with the Hungarian grievances and later gave assistance by restoring some of the confiscated parts to the mother country, thereby freeing about two and half million Hungarians from foreign oppression. As a result, Hungary found itself involved in World War II, again as an "unwilling satellite." WASS DE CZEGE, *supra* note 13, at 12; see JOHN MONTGOMERY, *HUNGARY, AN UNWILLING SATELLITE* (1947) (Mr. Montgomery is a former U.S. ambassador stationed in Budapest). The frontier revisions were later annulled by the new peace treaties, and unlike those in 1919-20, the Paris Peace Treaties of 1947 did not even stipulate the protection of national minorities. Kostya, *supra* note 13, at 113-14.

regard to other sectors.<sup>15</sup> The economic problems facing Hungary are directly traceable to the economic policies of the Communist regime, but their roots reach further back in time. Throughout their reign, the Habsburgs exploited Hungary. After their demise, it was Germany's turn to take advantage of Hungary's resources. Also, as a consequence of the 150-year-long Ottoman occupation and the subsequent Habsburg policies, Hungary's industrial development started some 100 years later than other European countries.<sup>16</sup>

The real infrastructure was put in place in the late nineteenth century. The economic recovery from the aftermath of World War I was gaining strength by the late 1930s only to have its development again interrupted by World War II.<sup>17</sup>

### c. *Social History*

A major problem underlying many other problem areas of Hungary stems from the country's social structure. The recovery from World War I was slow because the development of a market economy needs a strong middle class. However, before the war, Hungary's middle class lived primarily in those territories which were taken away from the country by the Trianon peace treaty. Two substantial segments of the bourgeoisie, the Jewish and German minorities, were also largely lost during and after World War II. A further drain on the country's middle class was the exodus of hundreds of thousands, mostly highly trained professionals, after the Soviet suppression of the 1956 Hungarian uprising.<sup>18</sup>

### d. *Institutional Framework*

In regard to the framework of political institutions, early Hungary followed the Western pattern of democracy; the country always had a parliament and a government.<sup>19</sup> Hungarian history demonstrates the remarkable capacity of this

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15. *Economic Renewal Without Shock Therapy*, FORTUNE, Special Advertising Section, Oct. 18, 1992 [hereinafter *Economic Renewal*]. As of 1992, Hungary had 10,337,000 inhabitants, with average annual rate of change -0.2%, an active working population of 4,241,800, and a GNP per capita of \$2982 with a growth rate of -7%. *Id.* Hungary experienced a total GNP drop of 18% in the period between 1989 and 1992. *An Interview with Béla Kádár*, FORTUNE, Oct. 18, 1992 (special advertising section) (Béla Kádár is the Minister of International Economic Relations in Hungary) [hereinafter *Interview with Béla Kádár*]. The fall had almost been checked by the end of 1993—the GDP only dropped 2% in 1993. *Institute Details E. Europe Economic Forecasts*, Reuters, Feb. 15, 1994, available in LEXIS, News Library, Curnws File [hereinafter *Economic Forecasts*]. The GDP has been forecasted to grow 1% in 1994. *Id.*

16. Pók, *supra* note 8.

17. *Id.*

18. *Id.*

19. *Id.* The Golden Bull of the year 1222 authorized the nation to resist by force of arms in case the king, exercising the powers of head of state, infringed upon the rights stipulated and contained in this bill of freedom. J. SZEMÁK, *LIVING HISTORY OF HUNGARY* 24 (1969) (J. Szemák was the last president of the Supreme Court of Hungary).



society to organize itself. By the time of the formal establishment of the state in A.D. 896, Hungary already had a long experience with developed political institutions and organizations.<sup>20</sup> In this century, this capacity was clearly manifest at the end of World War II and even more so during the ten days of the 1956 uprising.<sup>21</sup> It is posited that the main force shaping and defining the Hungarian nation is the sharing of values rooted in historical tradition and culture, rather than citizenship, living in a contiguous territory, or even speaking the same language.<sup>22</sup>

### 3. Contemporary Politics

After more than four decades of communism and Soviet military occupation, among all the countries of the East Bloc, the change in Hungary's political system is most remarkable for its complete absence of violence.<sup>23</sup> Among other factors, the change is not necessarily the result of only the democratic forces opposing the Communist regime, but also, and to a large extent, of important arrangements long planned and gradually introduced by members of the *nomenklatura*<sup>24</sup> itself.<sup>25</sup>

The constitutional base of the present Hungarian government was formulated under the previous Communist regime, although the then illegal opposition participated in its discussion. The pertinent secret agreement, "the pact" as it is referred to today, is considered by many as unduly restricting the ability of the new government to substantially change the distribution of actual power. This pact is the root cause of the political problems facing the country.<sup>26</sup>

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20. BOBULA, *supra* note 10, at 4.

21. Pók, *supra* note 8.

22. *Id.* The concept was forcefully expressed by Prime Minister Antall when he referred to himself as "the Prime Minister of 15 million Hungarians," pointedly including the five million living outside the country boundaries. Stephen Engelberg & Judith Ingram, *Now Hungary Adds Its Voice to the Ethnic Tumult*, N.Y. TIMES, Jan. 25, 1993, at A3.

23. Thomas, *supra* note 1.

24. In Communist countries, *nomenklatura* means (1) the list of all the jobs staffable only by trustworthy party members, and (2) the list of persons who hold, or are eligible for, those jobs. In post-Communist context, it refers to the residual set of people who were part of list (2).

25. János Dénes, *The World Must Draw the Lessons of Hungary's Fate*, ÚJ VILÁG [NEW WORLD], Nov. 5, 1993, at 7 (János Dénes is a member of the Hungarian parliament); István Morvay, *Hungary's Efforts to Stabilize the Region*, ÚJ VILÁG [NEW WORLD], Nov. 12, 1993, at 7 (István Morvay is the titular secretary of state, office of refugee and immigration affairs, Ministry of the Interior). For instance, their children had priority access to university education, often in the United States, and then subsequent claims on leading positions as "experts" in various enterprises and institutions. In the later part of the transition, there was also reportedly a large-scale transfer from the Communist party, security, and armed forces to civilian, cultural, and educational institutions. Dénes, *supra* at 7; Morvay, *supra* at 7.

26. László Révffy, *Munching on a Bare Bone*, ÚJ VILÁG [NEW WORLD], Nov. 5, 1993, at 6 (original in Hungarian). Concluded while Hungary was still under Soviet military occupation, allegedly in early 1990, also with U.S. and Israeli observers present, the pact has never been officially released nor has it ever been denied by the government. Its main points reportedly stipulate that nobody shall be put on trial for activities under the

The current composition of the parliament and other government agencies reflects the power distribution. Elected through multiparty ballot in early 1990, the present parliament has 176 of its 386 members directly elected, while the majority obtained seats according to their parties' share of the votes.<sup>27</sup> Only parties with at least four percent of the vote are eligible for parliamentary seats.<sup>28</sup> The assembly elected the prime minister from the largest party, the MDF, and the president from the second largest, now the parliamentary opposition party, SZDSZ. The government, in essence unchanged since 1990, consists of: the representatives of three so-called center-right parties with close to sixty percent of the seats; on the left, the intraparlimentary opposition with three parties; and a group of "independents," representatives who broke away from the other parties after the election but retained mandates. This system has proved rather stable.<sup>29</sup>

The very top of Hungary's government, specifically the ministers and state secretaries, has changed. At the next level of authority, there are officials of the old regime. The same applies throughout industry, agriculture, and business: Key positions are still filled by earlier appointees. After interim municipal elections,<sup>30</sup> about half of all the police chief positions around the country are still filled with their former Communist occupants; more than two-thirds of all mayoral offices of the country are still taken by appointees of the old regime.<sup>31</sup> Thus, the government also faces a formidable force composed chiefly of beneficiaries of the old regime and, occasionally, perhaps unknowingly, supported by unofficial or covert actions of the opposition parties. As a result, government initiatives,

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Communist regime; the new government shall accept responsibility for the borrowing of the old regime; there shall be no discrimination on racial or religious grounds; and some people shall get compensation for damages sustained under the Communist system. *Id.*

27. The Voting Act was published as Law XXXIV of 1989, enacted by the People's Republic Parliament on October 30, 1989, in *MAGYAR KÖZLÖNY*, No. 77, Oct. 30, 1989; Hungaricus Viator, *Election Mechanism*, *ÚJ VILÁG* [NEW WORLD], Aug. 6, 1993, at 4 (original in Hungarian); Ágoston Tömösváry, *Approaching Elections, Etc.*, *ÚJ VILÁG* [NEW WORLD], Aug. 6, 1993, at 4 (original in Hungarian); see also László Surján, Address Before the Fulbright Scholars in Budapest, Hungary (Sept. 3, 1992) (address by the minister of welfare).

28. The political spectrum and the amount of state subsidies allocated: extreme left—MSZMP (former Communist party, no parliamentary seats, HUF 28.1 million); left—MSZP (socialists, HUF 138.6 million); left-center—SZDSZ (democrats, HUF 236.3 million) and FIDESZ (young democrats, HUF 107.7 million); center—right—MDF (Hungarian Democratic Forum, HUF 255.5 million), KDNP (Christian Democrats, HUF 99.8 million), and Smallholder's fraction (36 seats, no subsidy figures available); right—Smallholder's Party (separated from government coalition, HUF 144.4 million) and about half a dozen other independent parties (most without seats or subsidies); extreme right—none. Robert Szalay, *Right and Left*, *ÚJ VILÁG* [NEW WORLD], Mar. 12, 1993, at 3 (original in Hungarian). One hundred Hungarian forint (HUF) equals approximately one U.S. dollar.

29. According to the constitution, passing major legislation needs two-thirds majority, approval by the president, and often also endorsement by the Constitutional Court (with old regime appointees acting as judges).

30. Amidst general public apathy, barely 20% of the eligible voters actually participated in the elections which returned the former officials, many of whom ran unopposed. Personal communication with election observers in Hungary.

31. In contrast, in the Czech Republic former Communist officials are barred from public office for five years; in East Germany, some 4400 officials were summarily dismissed; in Poland, Communist officials accused of atrocities face criminal prosecution.

especially in areas that would affect the status of the *nomenklatura*, are often stymied.<sup>32</sup>

The policies adopted by the current Hungarian government reflect a historical perspective<sup>33</sup> and aim at: (1) building a modern Hungarian society on the basis of strict observance of legality, pluralism, and at least nominal maintenance of historical values; (2) making the gradual transition to a Western European-type “democratic socialism” or at least to a “socialist market economy”; (3) playing a catalyst role in promoting close economic, cultural, and perhaps political ties with neighboring countries; and (4) joining the European community and its institutions.<sup>34</sup>

## B. International Forces

### 1. Hungarian Government Policies

As mentioned above, the government’s policies reflect a response to historical situations. This is particularly true with regard to international relations. To put things in perspective, it must be recognized that heterogeneity is a key characteristic of this part of Europe, even within individual states. Since time immemorial, Hungary has been one of the major crossroads of Europe, highly valued by foreign military forces, but much used by merchants too.<sup>35</sup> As a result, a basic aim of the Hungarian government is to turn this geographic position<sup>36</sup> from a disadvantage to an advantage, possibly serving as a base camp for various business-related activities.<sup>37</sup>

Additionally, it should be recalled that it was Hungary that started the destruction of the Soviet bloc and initiated the dissolution of the Warsaw Pact, both of which served as protected markets for Hungarian industry.<sup>38</sup> This dissolution relates to another top priority for Hungary, which is to be accepted

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32. Personal communication from local observers in Hungary.

33. Géza Jeszenszky, Address Before the Fulbright Scholars in Budapest, Hungary (Sept. 4, 1992) (address by the minister of foreign affairs).

34. See Susan Jansc6, *Boross: No Shift to the Right*, AM./HUNGARIAN J., Jan. 7, 1994, at 11. Péter Boross, the new prime minister, refuted rumors that his taking office would mean a shift to the right in the government. *Id.* “I am not a rightist, but I believe I stand somewhat to the right from leftists—was his political statement.” *Id.* Boross is an advocate of a practical, rational, and purpose-oriented government:

[Boross] promises to take a firm stand in protecting the interests of Hungarians within and beyond the borders, as well as protecting the values of a Christian-European culture. This is different from the cosmopolitan or internationalist standpoint, he stated. In politics, there is room for compromises that make sense, but this cannot mean giving up our principles and compromise on every issue.

*Id.*

35. Jeszenszky, *supra* note 33.

36. The scientifically calculated geographic center of the continent, marked near the ancient Hungarian city of Huszt a century ago, lies in the northeastern part of the Carpathian Basin, now part of Ukraine.

37. Jeszenszky, *supra* note 33.

38. *Id.*

and seen as a Western nation.<sup>39</sup> Acceptance derives from participation in the Council of Europe, the Western European Alliance, and an associate membership in the European Union (EU).<sup>40</sup> Hungary's government recognizes that the country needs time, perhaps a decade, to get ready to become a fully competitive member in the Union.<sup>41</sup>

On the regional level, the country continues its dialogue with Poland and the Czech and Slovak Republics.<sup>42</sup> The Hungarian government emphasizes its position that the former Communist countries have to learn the Western norms of human, civil, and minority rights, and through them find a way for the various nations of Europe to live in peace.<sup>43</sup>

## 2. Regional Developments

Another major problem in the field of international relations concerns the need to strike a deal with the emerging new states, especially with regard to national minorities. In this part of the world, nations do not coincide with states; there are significant ethnic islands of national minorities with states of their own in the "mother countries." In the view of Hungary's government, autonomy may be the solution, implying self-government for the ethnic communities.<sup>44</sup> Further, the evolving political and economic partnership with neighboring countries should help significant Hungarian minorities. The Hungarian government has been seeking all the international support it can muster for the achievement of this partnership.<sup>45</sup>

This endeavor has been met by Slovakia, Ukraine, Romania, and Serbia with mixed reactions. These reactions stretch from diplomatic refusal of the partnership concept to the outright accusation that Hungary has designs for the forceful reclaiming of territories taken after World War I.<sup>46</sup> The neighbors have vented

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39. *Id.*

40. European Union (EU) is the new name adopted by the former European Community (formerly the EEC and EC) on November 1, 1993. *European Union*, FIN. TIMES, Nov. 1, 1993, at 15.

41. Jeszenszky, *supra* note 33.

42. The dialogue started within the Visegrad Triangle. *See supra* note 12 and accompanying text (discussing the Visegrad Triangle). Recently, Ukraine also indicated interest in possibly joining the pact. *Poland Still Undecided on Slovenia, Ukraine in Visegrad*, CTK Nat'l News Wire, Feb. 22, 1994, available in LEXIS, News Library, Curmws File.

43. Jeszenszky, *supra* note 33.

44. The Hungarian parliament passed legislation regarding Hungary's own ethnic minorities. Pál Tar, Address Before the HACC, Commonwealth Club of California, and the World Affairs Council in San Francisco, Cal. (Sept. 15, 1993), in BUS. HUNGARY (Hungarian-Am. Chamber Com. in the U.S., Inc., Redwood City, Cal.), Fall 1993, at 2, 3 (address by ambassador from Hungary to the United States). This piece of legislation is considered a model by the Council of Europe and the country's Western European partners. *Id.*

45. Jeszenszky, *supra* note 33.

46. *Id.*

their displeasure on their Hungarian minorities, many of whom are forced to seek refuge in Hungary.<sup>47</sup>

It must also be noted that Hungary really has no choice but to pursue its foreign policy through peaceful diplomatic means since it was the country least trusted by the Soviet Union, and thus, given inferior armaments suitable only for internal security operations. Its neighbors have much better equipped armies and significant armament production capabilities.

### 3. Russia's Impact

The recently published Russian military doctrine<sup>48</sup> has important implications for Hungary and her relations with other countries, including the United States. The doctrine serves as a clear warning to former Warsaw Pact countries which seek to join NATO. An adjoining document states that Russia should pursue a "divide and influence" policy using force where necessary to "achieve firm good neighborliness."<sup>49</sup> Another Russian official document bluntly calls for "a new division of Europe into spheres of influence," implying the reimposition of their hegemony on Central and Eastern Europe.<sup>50</sup> This is not what the Hungarian government wants.<sup>51</sup>

Thus, Central Europe has greeted the Partnership for Peace initiative promoted by the United States with disappointment.<sup>52</sup> The initiative has been interpreted

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47. There is nervousness in the region about the possible extension of the current Yugoslavian conflict to the north and northeast. See e.g., Barry Newman, *Danube Blues—As Yugoslavia Burns, Nationalism Haunts Hungary's Peace Too*, WALL ST. J., Dec. 9, 1992, at A1.; Stephen Engelberg & Judith Ingram, *Now Hungary Adds Its Voice to the Ethnic Tumult*, N.Y. TIMES, Jan. 25, 1993, at A3. After his recent official visit to Belgrad, Csapody, MDF member of the Hungarian parliament, referred to increasing fear among the Hungarian minority of ethnic cleansing; some 600 Hungarian families would like to leave immediately but a mass exodus may develop, something Hungary's government would not like to see; Hungary does not have the resources to cope with the refugee problem. *A Vajdaságban Félnék a Tiszogatástól*, ÚJ VILÁG [NEW WORLD], Nov. 26, 1993, at 12 (original in Hungarian).

48. James Sherr, *Russia's New Threat to Neighbors*, WALL ST. J., Dec. 17, 1993, at A12.

49. *Id.* The threat is not that new or the result of the December 1993 elections and the January 1994 defection of reformists from the Russian government. *Id.* The underlying Russian foreign ministry document dates from December 1992. *Id.*

50. *Russia Threatens Neighbors—and NATO*, ÚJ VILÁG [NEW WORLD], Dec. 17, 1993, at 8.

51. See Tar, *supra* note 44, at 4.

[O]ur first king . . . christianized the Hungarians and, with the Hungarians, decided that we must be part of the West. We shared in European civilization through the ages and have considered ourselves Europeans. You can imagine the pain and suffering which resulted from our separation from Europe over the past 45 years. The Red Army occupied our countries, stayed there, and imposed upon us. Today, when we are free and independent, we want to demonstrate our "Europeness," our belonging to these values which we share with Europeans and Americans. . . . This gut feeling separates us from other areas to the east which never really belonged with western Europe and Western civilization.

*Id.*

52. Radek Sikorski, *Too Little Too Late for Central Europe*, WALL ST. J., Jan. 17, 1994, at A8. NATO's Partnership for Peace contains proposals for joint exercises, training, and consultations. *Id.*

as a sign that a number of NATO members, including the United States, would not be very happy to guarantee the "so-called" integrity of some of the region's countries.<sup>53</sup>

#### 4. *U.S. Influence*

The United States could greatly promote the healthy and peaceful development in the region by providing the same type of security commitment as the one that has made Western Europe's prosperity, and business potential for U.S. firms, possible over the past half century. This implies going beyond overly rigid insistence on maintaining the status quo while the underlying forces build up to explosive strength, as in Yugoslavia.

The absence of a credible commitment, such as would be demonstrated for instance by the proclamation of a firm timetable for their NATO membership, may force Hungary and its neighbors to slow down their internal reforms and integration with the West.<sup>54</sup> It may also lead to new forms of cooperation among the affected Central and Eastern European countries, possibly with different types of regional market challenges for U.S. firms, but with Hungary still in the center of the events.

### C. *Economic Forces*

#### 1. *Heritage of Central-Command Economy*

The current economic situation of Hungary results from four decades of a central-command economy.<sup>55</sup> The impact has been primarily negative. Most notable are the huge, inefficient factories and monopolies struggling to survive, many bankrupt or in liquidation. This is the worst part of the economic heritage: 200 companies in bankruptcy and most with a very bleak future.<sup>56</sup> Much of the financial difficulty facing these businesses resulted from their loss of large parts of their markets, especially in the former Soviet Union. The markets simply collapsed, with no real money to pay for deliveries. The temporary existence of these companies relies on enormous state subsidies.

Something new and hopeful appeared in 1968: limited and small-scale privatization, permitted but not supported, especially in small business and

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53. *Id.*

54. *Id.* The Czech Republic has canceled its planned army reduction. Poland also is likely to stop cutting its defense budget; money that should be allocated to credits for emerging private companies will be spent on restarting old Warsaw Pact arms factories. *Id.*

55. Károly Lotz, Address Before the Fulbright Scholars in Budapest, Hungary (Sept. 3, 1992) (address by SZDSZ member of parliament and deputy chairman of Committee on the Economy, National Assembly). See *supra* note 28 (explaining the political parties in Hungary).

56. Lotz, *supra* note 55.

household plots. Here, as compared to other Communist countries, Hungary had a favorable element in the economic heritage, but its significance must not be overemphasized.<sup>57</sup>

Additionally legacies were left in the form of a high level foreign debt and debt service which were the price of a relatively better life under the last period of the Communist regime.<sup>58</sup> The funds were used to keep big state monopolies afloat in Hungary, just like in other Communist countries, in addition to channeling a good part of the money to the Soviet Union. In effect, the hard currency borrowed by Hungary was transferred directly to the Soviets to enable their purchase of Western goods otherwise unavailable to them, or converted indirectly into rubles by the exportation of Hungarian-made goods.<sup>59</sup> Actually, Hungary produced goods which were quite good by Eastern standards; there was no need for any real marketing efforts. As a result, Hungary now faces a foreign debt of approximately \$22 billion,<sup>60</sup> or about \$2000 per capita, with an annual interest of about \$500 million.<sup>61</sup>

## 2. Hungarian Government Priorities

The Hungarian government has responded to the challenges left behind by the central-command economy with economic reform. The reform has three related priorities: privatization, stimulating foreign investment, and redirecting foreign trade.<sup>62</sup>

First, privatization of state-owned enterprises aims at reducing state ownership of the productive sector from the 1990 level of more than eighty percent to less than fifty percent by the middle of the decade. Here, the biggest difficulty is to carry out the privatization in a country where individuals have no savings to

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57. *Id.*

58. *Id.*

59. *Id.* The illegal smuggling of the latest Western computer technology to the Soviet military by the Communist government accounted for about \$2 billion; the building of two oil pipelines in the Soviet Union cost Hungary about \$3 billion. The financing of revolutions by the Soviets was done through Hungarian loans to Afghanistan, Cambodia, Cuba, Angola, Palestine, and Libya for \$1.5 billion. The yearly foreign currency income of certain factories, about \$600 million to \$700 million a year, was given by officials of the Hungarian National Bank at the order of the Communist government to the KGB to finance its operations of subversion. Notes from Julius Komjadi articles with added data and comments by Alfred Hamori, *Joseph Antall and His Bankrupt Rule*, ÚJ VILÁG [NEW WORLD], Dec. 31, 1993, at 7-8 [hereinafter Komjadi & Hamori].

60. *See id.* In 1982, Hungary owed \$3.6 billion in foreign debt; after the Communist regime started to follow IMF policies, loans intensified to such a degree that by 1985 the debt became \$15 billion, by 1989 \$20 billion, and rose to \$22 billion over the next four years. *Id.*

61. Lotz, *supra* note 55. In contrast, the total debt of the Czech Republic and Slovakia amounts to about \$2 billion. *Id.* Together with an internal debt of about HUF 400 billion, approximately \$4 billion, this indebtedness made all the steps of the new government more difficult and a truly independent economic policy impossible; no political power in Hungary today can free itself from this pressure. *Id.*; Morvay, *supra* note 25.

62. Jenő Hámori, Presentation at the Conference for "Business Ventures in Central and Eastern Europe: Building Strategic Alliances" in Budapest, Hungary (Nov. 12-15, 1990) (presentation by special counsel to the minister of international economic relations).

invest and where company candidates for privatization need major investment before they could be described as going concerns according to Western criteria.<sup>63</sup>

The area of foreign investment appears more encouraging.<sup>64</sup> By attracting foreign investors, the government's intention is not just to obtain funds, but also to (1) contribute to structural modernization; (2) bring in appropriate management culture and expertise (e.g., with regard to how business is done in free-market economies); and (3) facilitate the ease of transferring foreign technology into Hungary.<sup>65</sup>

Regarding redirecting foreign trade, the government can proudly point to some results although such are not necessarily in the originally targeted directions. The government wanted to do more trade with the West, however the trade which has developed has not necessarily been in that direction.

### 3. Trends

The present economic situation in Hungary is further affected by several trends.<sup>66</sup> Production of the big companies is declining while many new companies are forming and increasing production. There is a difference between these two trends in terms of rate of change. The downtrend of the last two years far exceeded the uptrend. In the coming year, a reversal of the situation is expected.<sup>67</sup>

Hungary's unemployment rate reached thirteen percent, or about 705,000 people at the end of 1993, and is expected to rise in 1994.<sup>68</sup> There are sharp differences in unemployment among regions of the country since bigger companies have profound impact and the effect of their bankruptcy can virtually

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63. Cf. Morvay, *supra* note 25, at 7 (discussing the factors that have made the Hungarian transitional phase toward free democratic elections more difficult). The so-called "spontaneous privatization process" began under the ancien régime when the *nomenklatura* created for itself the capability of rapidly acquiring state property. *Id.* A situation was created where the new democratic government would be unable to halt the economic transformation towards a free market economy started by the deposed regime because they would then have to violate the very principle of a free market economy. *Id.*

64. Hámori, *supra* note 62.

65. Critics refer to the process as a dumping of national wealth—pointing to the sale of the most productive units, some of them being "world-class giants," of the Hungarian economy, often to competitors. Komjadi & Hamori, *supra* note 59, at 7. Many times, these competitors shut down the factories. *Id.* The sales often took place at prices below the firms' net yearly profits. *Id.* One result of these sales is that 80% of the trade and distribution networks are in foreign hands today. *Id.*

66. Lotz, *supra* note 55.

67. "Adaptation to the challenges of the private sector comes quickly to Hungarians, who are characteristically bright, ingenious and hard-working . . . and thus, are putting together new businesses at a rapid rate." Alexander Tomlinson, *Hungary's "Little Guys" Think Big*, WALL ST. J., July 15, 1992, at A13. "As of 1993, fifteen thousand joint ventures have been set up in the country and 1,200 Hungarian firms set up operations in foreign countries." *Interview with Béla Kádár*, *supra* note 15.

68. *Hungary's Former Communists Launch Election Programme*, AGENCE FRANCE PRESSE, Feb. 28, 1994; Carol J. Williams, *Taste for Capitalism Slips in Nation Once Fed on "Goulash Communism,"* L.A. TIMES, Jan. 29, 1994, at A8.



erase jobs for major segments of the neighboring population.<sup>69</sup> There are areas with twenty-five percent or more unemployment.<sup>70</sup>

With limited natural resources, Hungary's economy is very open to the outside world; exports account for about fifty percent of the GNP. As a result, the economy is very sensitive to fluctuations in international trade and is quite vulnerable to any significant downturn in global business. Yet foreign trade is the most successful part of the Hungarian economy today. The dollar-denominated trade looks especially promising, including "eastern dollar exports," mainly to the Russian Federation and Ukraine. With the demise of COMECON, Hungary also lost access to low-priced Eastern raw material sources. The balance of payments now runs a surplus of \$400 million a year, compared to a \$300 million deficit ten years ago.<sup>71</sup>

Inflation presents a major problem; its rate has increased sharply since 1989, with a peak of thirty-five percent annual rate in 1991, and the annual inflation for 1993 averaging slightly over twenty-two percent.<sup>72</sup> Inflation is caused by liberalized prices and reduced subsidies, making Hungarian export products less price competitive.<sup>73</sup>

Hungary's budget deficit for the current year is forecast at HUF 180 billion to HUF 200 billion, which is about \$2 billion. Although the International Monetary Fund (IMF) is not particularly happy with the financial situation of the country, the main avenue of improvement is tied to substantial reduction in unemployment which may take many years to achieve.

Associate membership in the EU is new for Hungary, and the government hopes for full membership within a decade.<sup>74</sup> Its current associate membership status has already affected the country in significant ways.<sup>75</sup>

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69. Lotz, *supra* note 55.

70. In 1988 and 1989, some foreigners with carpetbagger attitudes arrived in Hungary, bought up state properties, and stripped them. *Interview with Béla Kádár, supra* note 15. Closing down the remains then created a virtual monopoly for the distribution of their own products coming from abroad. *Id.* This widespread practice of Western European businesses in Hungary has contributed to unemployment. This really amounts to a political problem: high unemployment is an entirely new phenomenon for Hungary which does not have the facilities, programs, or resources for the training and retraining of the unemployed, especially in the countryside where these aids would be needed the most. Lotz, *supra* note 55.

71. Tourism is a major source of foreign currency earnings. In 1990, the number of foreign visitors exceeded 3 million and has been increasing annually.

72. Lotz, *supra* note 55; Michael Shields, *Hungary's Socialist Lay Out Capitalist Agenda*, Reuter Eur. Bus. Rep., Feb. 27, 1994, available in LEXIS, News Library, Reueub File.

73. As an example, this may be compared to Czech goods with artificially low production costs due to their subsidized energy prices. Lotz, *supra* note 55.

74. One reason for the delay in achieving full membership is that the EU has to dispose of the application of 6 to 8 other countries before it can deal with Hungary's admission. Lotz, *supra* note 55.

75. The EU raised protective measures in response to its only recently abating recession; the French government's concern with the protection of its politically important farmers has led France to block the export of Hungarian agricultural products, which represent one of Hungary's very few areas of comparative advantage. In other areas, some relief is expected over the next five years through "asymmetric" export relationships, which would permit more export into the EU than export out of it. Lotz, *supra* note 55. Meanwhile, pain is felt at being

The Hungarian economy realized the gloomy projections for 1993,<sup>76</sup> with a negative growth in the GNP.<sup>77</sup> However, a modest real growth is anticipated for 1994 and beyond.<sup>78</sup>

#### D. *Social Forces and Values*

##### 1. *Structures*

Traditionally, the basic character of the Hungarians is described in terms of goodwill, tolerance, courage, and humanity. These are valuable qualities from the viewpoint of social evolution. However, these same qualities are very dangerous to those who display them too early.<sup>79</sup> This is painfully manifest in the apparent structuring of Hungarian society today, with important practical implications for U.S. interests. At the top, one can observe a small but very significant group of members who own profitable private businesses, luxury villas, and other signs of wealth. Some of these people are bona fide entrepreneurs, but most of them are functionaries of the old Communist regime, who are often still in control of important state enterprises, or retirees of the regime with sizeable pensions and other benefits.

The overwhelming majority of the population belongs to the middle and lower classes. These classes are best differentiated on the basis of education and occupation. The major group shares in economic hardship and outright poverty. Some of them try to survive in marginal private enterprises. In face of high prices and inflation, set wages and pensions, a harsh winter, and the prospect of further layoffs, members of this group also suffer from stress, disillusionment, and frustration.

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discriminated against by the West (the "Farmers' Wall replacing the Berlin Wall"), possibly also the shaping into a political argument ("You wanted the West, but the West doesn't want you."). See Michael Novak, *Don't Abandon Us*, FORBES, Jan. 17, 1994, at 51 (discussing Poland's perception of abandonment by the West).

76. Lotz, *supra* note 55; *Economic Forecasts*, *supra* note 15.

77. Interview with Béla Kádár, *supra* note 15. Hungary's fall in GDP was among the smallest of the former COMECON countries. *Id.*; *Economic Forecasts*, *supra* note 15.

78. *Economic Forecasts*, *supra* note 15. A lot of private-sector activity is still sub rosa, or at least substatistical. The National Bank of Hungary estimates that there are 500,000 unincorporated businesses; U.S. observers believe that "private enterprise currently may be accounting for as much as 40% or 45% of the real Hungarian gross national product." Tomlinson, *supra* note 67 (emphasis added).

79. BOBULA, *supra* note 10, at 41.

## 2. *Shapers of Public Opinion*

The majority of Hungarian newspapers<sup>80</sup> represent a more or less openly leftist attitude. The papers seldom, if ever, refer to anything negative about the defunct regime, but instead blame the current government for the economic problems or for not being democratic enough.

The state television and radio continued under its former *nomenklatura* leadership and editorial policy remained practically unchanged<sup>81</sup> until obvious falsification of documentaries resulted in a scandal that forced replacement of the guard in 1993.<sup>82</sup> Since 1993, commercial television broadcasts programs via satellite that cover Hungary and the neighboring territories with Hungarian minorities.

## 3. *Western Influence*

Before the political change of the late 1980s, there was a widely shared illusion that a multiparty system with a free market would be the universal cure for all the country's troubles. The model most often mentioned is the German welfare state.<sup>83</sup> This illusion contributed to the attitude of many, including university students in their early twenties, that the government should take care of the people, secure jobs, increase wages and pensions, provide free education all the way to the doctorate level, and guarantee free comprehensive health care.

Today, many view the concepts of market economy and entrepreneurialism as synonymous with usurpation, suppression, and exploitation. Western business executives, especially from Western Europe, must share the blame for this view due to their hit-and-run tactics, often in collusion with corrupt local officials.

It is also observed that some of the beneficiaries of the Communist regime are now living abroad, leading to suspicion towards foreign capital investors and even donors' funds. There is cynicism toward the government and politicians in general,<sup>84</sup> as well toward the outside world.

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80. *Népszabadság* (meaning "people freedom") is the newspaper with the largest circulation in Hungary and is the former official paper of the Communist party. Several dailies are owned by foreign interests. The government started its subsidized newspaper in late 1992 (with a circulation rate of one-sixth of the largest daily). Independent political groups have only weekly or monthly publications with limited distributions.

81. For instance, the inauguration of the first post-Communist government received five minutes of air time, and as recently as 1993, morning children's programs and evening adult entertainment routinely featured vintage Communist propaganda films, calling for such acts as class warfare.

82. The replaced president of Hungarian television was then invited to a California university.

83. This view overlooks the fact that the current state of German welfare is the result of some four decades of hard work invested in productivity improvements; in addition, by now and after all those investments, even Germany's leading politicians recognize that overspending is occurring, reducing the country's international competitiveness.

84. The public perceives even the democratic parties of the center as being infiltrated and manipulated from within by Communists. Morvay, *supra* note 25, at 7.

#### 4. *Workforce Implications*

The Hungarian workforce is young. For men, retirement age is sixty, for women, fifty-five, but many retire earlier or are simply laid off before reaching retirement.<sup>85</sup> The workforce is also well educated and willing to learn; with the proper motivation and under the right management, its productivity can be quite high<sup>86</sup> and available at a fraction of the wages paid in the West.

The desired nationwide change in fundamental values may take decades to accomplish. Some observers<sup>87</sup> see a potential source of the sought after values from Hungarians living outside the country long enough to have escaped significant Communist indoctrination and who could thus better preserve traditional ethical and moral standards.<sup>88</sup> Arguing that such expatriates “do not understand the situation,” other opinion leaders oppose any significant involvement of ethnic Hungarians from the West, except as more or less passive investors in Hungary. In any case, without seeing historic justice being done, the societal reconciliation is difficult to imagine.<sup>89</sup>

### III. LEGAL FRAMEWORK FOR BUSINESS

Since its beginning in early 1990, the current parliament of Hungary has enacted some 360 laws. However, many of the acts relevant to business date back to the previous regime. The framework created by these laws contributes to the investment opportunities and risks arising from the forces discussed in the previous section. This section examines the current status of the laws of primary importance to investment decisions, specifically, the acts addressing business forms, foreign investment, taxation, financial systems, and bankruptcy.

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85. See Valeria Kormos, *Worrisome Decline in the Health of Hungarian Women*, ÚJ VILÁG [NEW WORLD], July 2, 1993, at 13 (original in Hungarian). In Hungary there is no law against age discrimination in employment. Also, many are forced to retire early because of disabilities, especially women. *Id.*

86. Studies show that in the mid-1980s, Hungary's industrial workers were 50% as productive as Austrian workers. When Hungarian workers went to Germany under a cooperation agreement, after one year the productivity of these guest workers had risen to 95% of the German average. Hungarian human resources can become as productive as any in Western Europe. *Interview with Béla Kádár, supra* note 15.

87. András Márton, Address Before an Assembly of Americans of Hungarian Origin in Woodside, Cal. (1992) (address by the Consul General of Hungary in Los Angeles, California).

88. As a hopeful sign of changes already under way, the most frequently requested topic to be presented by a visiting U.S. professor was the business ethics of U.S. firms (to contrast them with Western European practices, as observed by Hungarians, to often be on the seamy side) and how they might be introduced in Hungary.

89. *A Magyar Nép Európai Módon Viseli az Átalakulással Járó Nehézségeket*, MAGYAR NEMZET, Sept. 17, 1992, at 1 (discussing Prime Minister Antall, in a parliamentary debate over the government's first two years) (original in Hungarian).

## A. Company Act

Enacted in 1988, the Company Act gives unequivocal guidance to foreign business executives with regard to the forms of economic association that can be established.<sup>90</sup> The Act also provides details about the legal and financial framework within which they can operate.<sup>91</sup>

There are six different forms of business entities in Hungary: two limited company forms and four partnership forms.<sup>92</sup> The limited company forms consist of the company limited by shares and the limited liability company.<sup>93</sup> The four partnership forms comprise the unlimited partnership, the limited partnership, the business union, and the joint enterprise.<sup>94</sup> As foreign investment will occur primarily in connection with the limited company forms rather than the partnership forms, a description and comparison of the forms is pertinent to investment decision.

### 1. Company Forms

A company duly formed and registered according to Hungarian law is a legal entity; permission is not required for the formation of a company, even if the shares are wholly foreign owned.<sup>95</sup> A company may, in its own name, acquire rights, enter into commitments, acquire property, conclude contracts, bring actions, and be subject to actions brought against it.<sup>96</sup> Although a company can have a wide scope of activities, there are some activities that need special government permission.<sup>97</sup>

A limited liability company, denoted by "Kft," is established with a predetermined amount of initial capital deposited by its members.<sup>98</sup> The members' liability is limited to the total contributed initial capital and any subsequent contributions to capital. No single member is responsible for the company's liabilities.<sup>99</sup> Members may not be recruited through public advertise-

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90. *Foreign Capital in Hungary* 32-34 (undated handout obtained from the Hungarian consulate general on Dec. 6, 1993) (on file with author).

91. *Id.*

92. *Structure of Business Entities* 29 [hereinafter *Business Entities*] (undated handout obtained from the Hungarian consulate general on Dec. 6, 1993) (on file with author).

93. *Id.*

94. *Id.* The term "joint venture" is used commonly in Hungary to refer to any type of business association or company established in accordance with Hungarian law that is partially or wholly foreign owned. *Id.*

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.*

ment.<sup>100</sup> This form of company may be established by a single person or party.<sup>101</sup>

A company limited by shares, known as an "Rt," is established with a predetermined amount and nominal or issue value of the shares.<sup>102</sup> Members are not otherwise liable for the company's obligations.<sup>103</sup> The members of a company limited by shares, other than a closed foundation, may be recruited through public advertisements. All the shares of closed foundations must be purchased by the founders.<sup>104</sup>

## 2. *Basic Differences in Company Forms*

The two company forms differ in many important ways. First, regulation of the Kft is dispositive—its articles of association may deviate from the Company Act except for specific provisions stated in the Act.<sup>105</sup> In contrast, regulation of the Rt is comprehensive, its articles of association may not deviate from the Act unless expressly allowed by the Act.<sup>106</sup>

A one-person Kft may be formed without any restriction, but an Rt with only one shareholder may be established only by the state budgetary organization or a financial institution.<sup>107</sup> However, after the establishment of an Rt by two or more founding shareholders, the shares of an Rt may be transferred to and held by one shareholder.<sup>108</sup>

Additionally, the minimum required share capital of a Kft is HUF 1 million.<sup>109</sup> The cash contribution to the capital of a Kft must be the greater of thirty percent of the issued capital or HUF 500,000.<sup>110</sup> In comparison, an Rt requires a minimum share capital of HUF 10 million, with a minimum cash contribution of the greater of thirty percent of the issued capital or HUF 5 million.

With a Kft, a supervisory board is not mandatory unless its share capital exceeds HUF 20 million, the number of shareholders exceeds 25, or the number of employees exceeds 200.<sup>111</sup> In contrast, all Rts must establish a supervisory board.<sup>112</sup>

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100. *Id.*  
101. *Id.*  
102. *Id.*  
103. *Id.*  
104. *Id.*  
105. *Id.* at 30.  
106. *Id.*  
107. *Id.*  
108. *Id.*  
109. *Id.*  
110. *Id.*  
111. *Id.*  
112. *Id.*

Unless a Kft is a wholly owned subsidiary or its primary share capital exceeds HUF 50 million, the appointment of an auditor is not mandatory and not all Kfts must publish audited annual reports.<sup>113</sup> In comparison, all Rts are required by law to appoint an auditor and must publish audited annual reports.<sup>114</sup>

## *B. Foreign Investment*

### *1. Principles*

The law regulating foreign investment establishes the principles concerning the functioning of economic entities with foreign participation.<sup>115</sup> Among other things, the law and its current implementation:

- (1) Make the Hungarian forint a de facto convertible currency for foreign trade;
- (2) guarantee the investment through international and bilateral agreements;
- (3) permit one hundred percent foreign ownership;
- (4) permit full repatriation of profits in convertible currency;
- (5) allow duty free imports of goods necessary to establish a joint venture; and
- (6) ensure that foreign exchange is available on demand to conduct business.

### *2. The Concessions Act*

Passed in early 1991, the Concessions Act provides investors with concessions in return for investing in the development of infrastructure and specific sectors in Hungary.<sup>116</sup> The Act lists those activities where the concessions legislation applies if private capital is involved. The activities include the construction of roads, railways and airports, rail transport, telecommunications, power generation and transmission, mining, games of chance, and postal services.<sup>117</sup>

The state monopoly has not been abolished in these areas, but is regulated by parliament, or, in the case of local council rights, by the local mayor.<sup>118</sup> The Act provides the conditions under which the state can continue with its own companies in the specific areas or license the rights.<sup>119</sup> The state, represented

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113. *Id.*

114. *Id.*

115. *Foreign Capital in Hungary, supra* note 90, at 33.

116. HUNGARIAN INVESTMENT AND TRADE PROMOTION AGENCY, HUNGARY: THE FIRST CHOICE FOR BUSINESS IN CENTRAL-EASTERN EUROPE 3 [hereinafter HUNGARY: THE FIRST CHOICE] (undated brochure obtained through the courtesy of the Hungarian Consulate General, Los Angeles, California).

117. *Id.*

118. *Id.*

119. *Id.*

by the appropriate ministry, defines how concessions will operate in specific sectors.<sup>120</sup>

### 3. *Privatization Programs*

To transfer state assets<sup>121</sup> into private hands, the Hungarian government established the State Property Agency (SPA) which has launched several privatization programs since 1990.<sup>122</sup> The most prevalent methods of privatizing companies are the following:

- (1) First, the privatization process is actively initiated by the SPA or government, as investors tender in open or invited bidding to buy the companies offered for sale.
- (2) The second method can be initiated by state-owned companies themselves, and regulated by the SPA, as the company seeks a strategic partner.
- (3) The third type is the so-called self-privatization which allows small and medium-sized firms to privatize themselves with the assistance of SPA approved consultants. This procedure avoids SPA controls and expedites transactions.
- (4) The fourth method is investor initiated privatization, where foreign investors target specific Hungarian companies and approach the SPA jointly with the chosen candidate for approval.<sup>123</sup>

## C. *Tax System*

### 1. *Principles*

Hungary has a self-assessment tax system. Taxpayers are required to register, determine their tax obligations, make advance tax payments, file tax returns, make corrections to tax returns, keep records, and supply information as required by law.<sup>124</sup>

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120. *Id.*

121. Most of the assets involved, specifically land, houses, businesses, and industrial properties, were forcefully seized from their private owners by the Communist regime, but ownership was not restored under the new government. A modest amount of partial compensation is paid to former owners, or their descendants, in the form of vouchers which, now sold in open markets at close to half their face value, can be used as partial payment, if accompanied by cash, to purchase property under "privatization." The vouchers can be acquired by foreigners. The Act was published as Law XXV of 1991, enacted by the People's Republic Parliament on June 26, 1991, in *MAGYAR KÖZLÖNY*, July 26, 1991.

122. HUNGARY: THE FIRST CHOICE, *supra* note 116, at 6.

123. *Id.*

124. *Tax System* (undated handout obtained from the Hungarian consulate general on December 6, 1993) (on file with author).



## 2. Corporate Income Tax

Companies incorporated in Hungary are subject to corporate income tax on their worldwide profits.<sup>125</sup> Foreign companies carrying out taxable activities in Hungary are subject to corporate income tax on their net profits derived from Hungarian sources.<sup>126</sup> The standard rate of income tax is forty percent.<sup>127</sup> However, qualifying companies engaged in certain industry sectors may be able to obtain tax abatements.<sup>128</sup>

Foreign investors in these government-designated sectors, through entities legally established in Hungary before December 31, 1993, receive a 100 percent tax exemption for the first five years and 60 percent for the next five years.<sup>129</sup> In addition to the requirement that at least fifty percent of the entity's income be derived from activity in government-designated sectors, the investments must have at least thirty percent foreign participation and at least HUF 50 million of capital.<sup>130</sup>

As an alternative, foreign investors may be eligible for a sixty percent tax exemption for the first five years and forty percent for the next five years.<sup>131</sup> To qualify for these exemptions, these investments must have at least thirty percent foreign participation and at least HUF 50 million of capital.<sup>132</sup> Additionally, the investors must invest and generate more than half of their gross revenue through manufacturing activities.<sup>133</sup> The amount of dividends reinvested can be used to redo the tax base. The last year for which such tax abatement can be used is 2003.

Starting in 1994, however, granting some of these exemptions to a particular enterprise will be the subject of government discretion, with preference going to larger firms. For instance, the deductibility of reinvested earnings will in principle be available to firms with at least \$100 million of capital or with at least \$25 million of reinvestment. The tax holidays will be offered to companies with at least \$500 million of capital which invest at least \$200 million, have up-to-date products, are environment friendly, create export earnings, and new employment.<sup>134</sup>

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125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.*; Act LXXXVI of 1991, *Corporate Tax*, NEWSLETTER HUNGARY 7 (No. 2, Special Edition) (Anna Dániel, Information Service, Ministry of Int'l Econ. Rel. ed., 1992) [hereinafter *Corporate Tax*] (citing chapter 3, § 12 of the Act).

129. *Corporate Tax*, *supra* note 128, at 7-8 (citing chapter 3, §§ 12(1)(a), (9)).

130. *Id.* (citing chapter 3, § 12(1)(a)).

131. *Id.* (citing chapter 3, § 12(1)(b)).

132. *Id.*

133. *Id.*

134. Zoltán Muzslai, *How Is Foreign Investment Attracted in 1994?*, HUNGARIAN/AM. J., Jan. 21, 1994, at 3 (original in Hungarian).

### 3. *Personal Income Tax*

Residents of Hungary are taxed on worldwide income if they reside in Hungary for at least 183 days in a tax year.<sup>135</sup> Nonresidents are taxed solely on income from Hungarian sources.<sup>136</sup>

Under the Hungarian personal income tax system, taxable income is generally taxed at progressive tax rates of twenty-five to forty percent based on income brackets, with the maximum rate beginning at a taxable income of HUF 500,000.<sup>137</sup> The tax on interest income from Hungarian sources is generally subject to a final withholding tax at a rate of twenty percent.<sup>138</sup> Effective January 1, 1994, interest paid on foreign-currency accounts held in Hungary is subject to a withholding tax of ten percent; this tax need not be paid in Hungary if, on the basis of an agreement excluding double taxation, the interest is subject to taxation in the country of the nonresident beneficiary's domicile.<sup>139</sup> With respect to the tax on dividend income, if it is derived from Hungarian sources the income is subject to a final withholding tax at a rate of ten percent, if the company paying the dividends pays corporate income tax at normal rates, and in other cases, the rate is twenty percent.<sup>140</sup> The twenty percent rate also applies to capital gains.<sup>141</sup>

### 4. *Value-Added Tax*

A value-added tax (VAT) is levied on domestic sales and on the importation of goods and services at a general rate of twenty-five percent.<sup>142</sup> However, rates vary depending on the nature of the goods or services involved. Many of the basic goods and services are taxed at six percent. Residential electricity and medicine are not subject to the VAT.<sup>143</sup>

### D. *Support Systems*

Within the last ten years, many of the financial support systems which are critical to investment have been revamped. The areas which have been improved include the banking system, securities trading, and the financial reporting and accounting system.

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135. *Tax System, supra* note 124.

136. *Id.*

137. *Id.*

138. *Id.*

139. Act CI of 1993 (enacted by the People's Republic Parliament on Nov. 23, 1994).

140. *Tax System, supra* note 124.

141. *Id.*

142. *Id.*

143. *Id.*

As a first in Central and Eastern Europe, in January 1987, Hungary introduced a two-tier banking system with a series of reforms that separated the functions of commercial banking from that of the central bank, the National Bank of Hungary. The National Bank of Hungary was made independent of government and accountable to the parliament.<sup>144</sup> As of 1993, there were scores of commercial banks, some wholly Hungarian owned, others joint foreign-Hungarian operations, with about a thousand branches across the country.

In February 1990, before the election of the present parliament, the Act on Securities passed. After this, the Budapest Stock Exchange reopened and now conducts active trading in scores of securities.

The Hungarian financial reporting and accounting system has in the past often reflected changing political considerations which made evaluations in U.S. terms practically impossible. As of 1991, this system was revamped to make it compatible with international norms.<sup>145</sup>

Additionally, Hungary concluded agreements with twenty-five countries, including the United States, for the protection of foreign investment and the avoidance of double taxation.<sup>146</sup> The country is also covered by guarantees of the Multinational Investment Guarantee Agency (MIGA) of the World Bank.<sup>147</sup>

#### *E. Bankruptcy*

The Bankruptcy Act of 1991 allows state enterprises, like any other firm, to file for bankruptcy, provided there is a chance of recovery.<sup>148</sup> In such a case, the program of rehabilitation usually includes a measure designed to transform the enterprise into a business company. One of the possibilities open to creditors is to acquire an interest or share in the debtor firm. Thus, privatization, possibly with foreign investor participation, is closely related to proceedings regulated by the Bankruptcy Act.

The same applies to liquidation of state enterprises and state-owned companies. A court-appointed liquidator sells the assets, not so much concerned with whom the buyer is, but rather, with fast implementation of the sale and agreement on a suitable price. Here, the SPA, entrusted with the administration of state assets, is given two well-defined tasks: one directly arises from the quoted provisions of the Bankruptcy Act and another, an obligation incumbent on the owner, as seller, to formulate the sales conditions.

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144. *Economic Renewal*, *supra* note 15.

145. *Foreign Capital in Hungary*, *supra* note 90, at 33.

146. *Id.*

147. *Id.*

148. Dr. Róbert Szakál, *Bankruptcy and Privatisation* (obtained from the Hungarian consulate general, Dec. 6, 1993) (on file with author).

#### IV. IMPLICATIONS FOR U.S. BUSINESS

The enactment of the laws discussed in the previous section demonstrates the Hungarian government's recent efforts to encourage investment in the country. These laws, in addition to the forces shaping the business environment, have created the opportunities and risks which will be encountered by the Western firm interested in doing business in Hungary. This section examines some of these opportunities and risks which have already been identified and suggests a four-stage model to be utilized by the business in the formulation of its investment strategy.

##### A. *Opportunities*

###### 1. *Market Opportunities*

In Hungary, just like throughout Central and Eastern Europe, market opportunities are created by obvious needs for capital and technology, as well as by the less generally recognized, but psychologically much more important, needs for unimpeded access to the rest of the world's products and resources. Above all, there is need for knowledge, especially regarding effective market-oriented business management.<sup>149</sup>

Like the rest of the region, Hungary can be characterized as middle income, with GNP-per-capita figures at a quarter to a half of the average for Western Europe.<sup>150</sup> The Hungarian situation is further reflected in various aspects of general welfare such as infant mortality, life expectancy, diet, and number of hospital beds per capita. At the same time, the expectations—e.g., with regard to material possessions, life styles, and consumption patterns—are on par with those of the West and, thus, create a wide gap. This situation creates an enormous business opportunity and not just in terms of markets for tangible products.

Physical products, facilities, or services are called for to meet the primary needs directly. Also, they serve as means of satisfying other wants, preferences,

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149. J. Leslie Jankovich, *Business in Eastern Europe: Is It for Your Company?* (Presentation to the Manufacturing Advisory Board, College of Business, San Jose State University, Oct. 25, 1991, San Jose, California) (on file with author).

150. Considering only seven countries of Central and Eastern Europe, Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia, this region of some 100 million people lies in the very heart of the continent at the crossroads of all north-south and east-west communications, potentially tying together 700 million Europeans with a combined GNP in excess of \$8 trillion. DANIELS & RADEBAUGH, *supra* note 4, at 399-400; THE INFORMATION PLEASE ALMANAC (47th ed. 1994).

and aspirations, perhaps corresponding to higher psychological levels in the hierarchy of needs.<sup>151</sup>

U.S. firms contemplating the indicated market opportunities may well recall one of their most important and highly relevant assets: their ability to assess market needs and to respond by producing and delivering the appropriate product on time and at a competitive cost, thereby creating value for the customer at a profit for themselves. It is this ability which is badly needed throughout the countries of Central and Eastern Europe and may by itself become a profitable "export product."<sup>152</sup>

## *2. Resource Opportunities*

Some U.S. firms have not succeeded in coping with all their challenges from a U.S. base. Factors contributing to this failure include uncertain state government attitude toward business, frequently changing regulations and additional unitary tax burdens, the resulting higher cost and risk, as well as the subsequent negative impact upon their global competitiveness. These firms have been forced to consider locating at least some operations abroad.

An alternative to coping with local cost and obtaining a competitive edge is through "outsourcing": obtaining resource inputs to various stages of the production process from other countries. Such production sharing may amount to vertical integration,<sup>153</sup> the success of which depends on determining: (1) how broadly integrated the firm should be at a particular time, (2) how much of each task should be done internally, and (3) what form the venture's ownership and management should take.<sup>154</sup>

## *3. Best Prospects*

Some of the specific areas which offer promising market or resource opportunities for U.S. businesses in Hungary have been identified and listed in a

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151. For instance, telephone and unimpeded access to the global communication network are considered by many in the region as basic political rights—long denied to them by the totalitarian regime—and as such, some argue, not just to be safeguarded, but also to be made available to everybody at an affordable cost by the government. Similar arguments can be heard, albeit voiced with less vehemence on the spot, about health care and environmental concerns.

152. J. Leslie Jankovich, *Cross-National Strategy Approach to Eastern-European Business Venture Development* (Presentation at the Conference for Business Ventures in Central and Eastern Europe: Building Strategic Alliances, sponsored by Virginia Polytechnic Institute and State University and Old Dominion University, Nov. 12-15, 1990, Budapest, Hungary) [hereinafter Jankovich, *Cross-National Strategy*] (on file with author).

153. Jankovich, *Business in Eastern Europe*, *supra* note 149.

154. Kathryn R. Harrigan, *A Framework for Looking at Vertical Integration*, *J. BUS. STRATEGY*, Winter 1983, at 30, 30-37.

publication obtained from the Hungarian consulate general.<sup>155</sup> The opportunities are:

*Food manufacturing and packaging equipment.* Hungary exports much of her agricultural products, although a large share is exported at a low degree of processing. There has been little emphasis on packaging and thus there are considerable opportunities for packaging equipment.

*Telecommunications equipment.* The development of the country's telecommunications infrastructure enjoys the highest priority, creating opportunities in all areas. A ten-year development project, with a total cost of nearly \$6.3 billion, is in progress; it will include three million new telephone lines, data transmission facilities, digital transmission and switching, optical fiber transmission, and an integrated digital service network. The first, three-year stage of the program is nearing completion. The program superimposes a new digital network on the old system.

*Tourism.* Outside the touristy regions of Budapest and Lake Balaton, numerous regions have remained underdeveloped for tourism. In Hungary, there is a shortage of high- and medium-standard hotel accommodations; also missing are such exclusive establishments as golf courses, boat houses, and hunting lodges.

*Computers and peripherals.* Hungarians are among the best computer-trained people in the world and famous for their quality software. After the abolition of the COCOM restrictions there is considerable demand for the development of information technology as an instrument for increasing productivity and competitiveness. Although several important manufacturers exist already in Hungary, the market is not yet saturated.

*Construction industry.* The construction industry will play a major role in the reconstruction of the Hungarian economy. In essence, the entire infrastructure stands to benefit from the large investments. The transportation systems need development and there is a shortage of apartments and office buildings.

*Medical instruments.* Hungary's health care system uses little advanced medical technology, like electro-medical, microsurgical, X-ray equipment, novel diagnostic instruments, and dental equipment. Since the government stimulates the privatization of health care, the market for new medical equipment will open up gradually.

*Pollution control equipment.* Reckless industrialization under the previous regime has caused great environmental damage throughout Central and Eastern Europe. In Hungary, the local and urban administrative agencies have now given priority to the control and cleanup of pollution but capital and technology are lacking.

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155. *Foreign Capital in Hungary*, *supra* note 90, at 33-34.

**Energy.** The productivity and efficiency of energy are below the Western average. Hungary has started an ambitious program for building power stations and for linking energy networks. Also, Hungary plans to replace some of the imported natural gas with the development of energy from agricultural waste.

**Household and consumer goods.** Hungary has a large industry segment manufacturing consumer goods, although quality is not always up to the Western norms. There is still great demand for Western consumer goods and appliances.

**Agriculture.** The SPA has started the program of privatizing state farms, partly stimulated by strong foreign interest. Foreign investments can acquire an interest in any or all aspects of the process—from production to distribution.

**Expo '96.** A comprehensive business opportunity is offered by the World Expo, planned for May to October 1996, in south Budapest. Being developed in collaboration with Bechtel International, its theme is communication for a better world. Participants include fifty-two countries, and various multinationals. An attendance of fifteen million visitors is estimated.

## **B. Risks**

### **1. U.S. Perceptions**

One crucial force affecting risks and opportunities, challenging U.S. business in Hungary stems from U.S. government policies, reflecting the U.S. perceptions of the Hungarian situation. According to the U.S. ambassador in Hungary, the country's transition has been remarkably smooth. Its government is stable, with the same president and prime minister since 1990.<sup>156</sup> This period of political stability can be expected to continue.<sup>157</sup>

In more practical terms, the United States has extended the most-favored-nation status, together with the coverage of its foreign trade and investment insurance programs to Hungary. A \$70 million fund for the promotion of new enterprises in Hungary has been established.<sup>158</sup> In addition, the United States has been financially and politically supporting the transfer of intangible resources through professional exchanges between the two countries.

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156. Thomas, *supra* note 1. The prime minister in question, József Antall, died while in office on December 12, 1993. His successor, Péter Boross, emphasized continuing commitment to the same principles and minimum change in the composition of government. *See also supra* note 34 and accompanying text (discussing the plans of Prime Minister Boross).

157. Thomas, *supra* note 1. The quoted emphasis on stability may be considered as reflecting the importance our government attaches to its role in securing conditions favorable for its enterprises doing business abroad.

158. Tomlinson, *supra* note 67. To encourage the development of the private sector through equity investments and loans, the Hungarian-American Enterprise Fund, a tax-exempt corporation funded by Congress, made commitments of \$35 million to 120 enterprises as of mid-1992, according to its president and CEO, Alexander C. Tomlinson. *Id.*

U.S. business executives support the government's position. In a 1990 survey comparing Eastern European countries for chances of business success, CEOs rated Hungary very highly in terms of readiness and ability to change and economic development potential. The ranking closely paralleled the capital spending plans for Western firms in the region.<sup>159</sup>

Actual developments have vindicated the assessment. As of the end of 1993, approximately \$5.5 billion in foreign capital has flowed into Hungary. To put this figure in perspective, Hungary, with two percent of the population of the former East Bloc states, has attracted almost sixty percent of the total foreign investment to the area. U.S. investors have contributed the lion's share.<sup>160</sup> Since the latter part of 1992, however, the growth rate of foreign investment in Hungary has slowed.<sup>161</sup>

## 2. *Business Risks*

For many American firms, doing business in Hungary brings types of uncertainty usually not encountered in the United States. For instance:

- (1) Market assessment by standard marketing methods is more difficult because (a) past consumption patterns and trends may be less indicative of the future, (b) the GNP and industry sectors are more affected by other factors, (c) there is less market-related information available, and (d) the public attitude toward markets reflects more distrust and different expectations.
- (2) Competitive risk differs because of the presence of state-owned or state-supported companies. There is also very strong Western European, especially German, business participation.<sup>162</sup>
- (3) Legal uncertainties stem from the practical enforceability of contracts, other aspects of international codes of conduct, and possible changes of the applicable laws.<sup>163</sup>

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159. DANIELS & RADEBAUGH, *supra* note 4, at 372-74.

160. *Economic Renewal*, *supra* note 15.

161. Tim Carrington, *Eastern Europe's Ills May Defy Usual Cures*, WALL ST. J., Dec. 7, 1992, at A1; Jane Pelez, *Eastern Europe's Promise Fades*, N.Y. TIMES, Feb. 21, 1993, § 3, at 17. The cause of the slowdown may also be found in the belt tightening and tax increases introduced by the government in response to IMF conditions set for a standby credit. See *Economic Renewal*, *supra* note 15.

162. It must be remembered that these competitors are, of course, not subject to the same restrictions as U.S. firms. E.g., The Foreign Corrupt Practices Act of 1977, 15 U.S.C. §§ 78dd-1 & -2 (1993).

163. In view of possible U.S. firm involvement in pertinent activities in Hungary or elsewhere in the region, the applicability of RICO needs careful consideration. See 18 U.S.C §§ 1961-68 (1993).



### 3. *Political Risks*

Political change and associated risk may result from economic downturn, prolonged recession, social unrest, or ethnic tension. At a more fundamental level, the root cause may be the perceived discrepancy between the relative importance of contributions to, and expectations of, return from the establishment by various groups. This may lead to widespread frustration and ultimately a determination to change the political landscape. This change may not be constitutional. Thus, political sources of uncertainty and risk comprise a broad range of possible changes, such as: institutionally prescribed elections, fall of a cabinet, outlawing a significant group, coup d'etat, civil war, or even armed intervention by a foreign power. All these possibilities are not equally probable to occur, nor are all the probable consequences equally severe for foreign enterprises.

### 4. *Scenarios*

The most immediate event that may bring change is the parliamentary election scheduled for spring 1994. Issues relevant to U.S. businesses in Hungary are property ownership rights; the government's role in the economy and welfare; Hungary's foreign and internal debt; *nomenklatura* participation in public life; position with regard to the defunct Communist regime; relationship with Hungarians abroad; political, if not economic, positioning of the country with regard to the East and West, Russia and the United States; and the overarching value system governing the choices.

A few scenarios may help to determine the range of possible election outcomes and their implications. For instance:

- (1) From the viewpoint of U.S. business involvement in Hungary, a worst-case scenario is a complete return to the old Communist regime and state-run economies, with attendant nationalization and disruption of market access. This is not a very probable development since even in its last years, the enlightened self-interest of the Communist regime allowed Western ownership and operations with some restrictions.
- (2) A more probable scenario is the return of a left-wing regime, including liberal democrats, reform Communists, *nomenklatura* members and their children, with a cosmopolitan outlook. This would close the books on the Communist regime's activities permanently, establish a type of social democracy with more state involvement in the economy, attack inflation by nonmonetarist means, and control wages and prices. In addition, the regime could continue subsidies to weak enterprises and the agricultural sector, continue heavy debt financing, increase internal security expenditures, and restrict expressions of challenge from the right, with benign neglect of Hungarians abroad. However, Western investors and participa-

tion in privatization would still be welcome. Thus, the change from the status quo would be relatively modest. In spite of the short-term stability of this scenario, however, these policies may continue alienating broad segments of society and create more pent-up frustration, which in the long run may lead to more radical changes.

- (3) Still another possible scenario may be that no change will occur in the current political alignment and, consequently, the present economic and legal systems will prevail for some time to come.
- (4) Another plausible scenario may be the emergence of a regime reflecting the positions of independent and national tradition-oriented parties, representing a broader segment of the population. In the short run, such a regime may change more of the rules with regard to the return of nationalized property to former owners. The regime may also tax newly acquired wealth, place a moratorium for public office on *nomenklatura* members, continuing repayment of that part of the country's foreign debt which was actually used in Hungary, reduced government role and size, and even tax reduction to stimulate the economy. Thus, this scenario represents a more significant change from the current situation. Yet, to the extent that such a system enjoys broad public support, it may well lead to long-term stability and a solid base for profitable involvement of American business.
- (5) Another scenario may be the realignment of international political boundaries discussed above. As manifest in various parts of the former Soviet Union and Yugoslavia, such a change may well involve violence, damage to life and property, disruption of access to earlier supplies and markets, and perhaps the emergence of new political and business associations with outside entities.

The actual outcome may fall somewhere between the extreme possibilities. In fact, significant resources are being committed to the avoidance of major changes.<sup>164</sup>

### C. *Ways to Cope*

To cope with the challenge of investing in Hungary, careful consideration should be given to the full range of possible entry and involvement forms, from initial exporting through licensing, management contracts, and joint ventures, to

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164. For instance, on December 14, 1993, the parliament turned down a bill that would have allowed Hungarians living abroad to vote; a proposal that would raise the minimum percentage of the vote required for parliamentary representation to 5%, and apply it to each member party of a coalition, etc. Additionally, more than 120 new parties have registered for participation in the elections.

fully owned subsidiaries. Additionally, in relation to each form, the required resource commitment, expansion potential, and related risk should be calculated.

In order to secure the benefits of doing business in and around Hungary and reduce the range of associated uncertainties, interested U.S. firms are well advised to:

- (1) Plan strategically, which involves the consideration of involvement in Hungary and the region as a complement to the firm's current and envisioned business ventures. Businesses must look carefully and take a long-term view.<sup>165</sup>
- (2) Start with low profile (export, license, franchise), proceed gradually, develop confidence and mutual trust, always stick to highest ethical standards, know and respect the applicable laws of Hungary and the United States.
- (3) Learn on the spot, use a carefully selected local partner, be ready to educate, and plan on extended local presence.
- (4) Develop mutually beneficial two-way flows of goods, tangible and intangible exchanges (e.g., "hostage taking").
- (5) Form joint ventures with able, well-connected local partners; however, keep a key resource or link outside the country (e.g., R&D capability).
- (6) Regularly perform political risk analysis as part of strategic planning: identifying key elements of applicable cause-and-effect model, assessing probabilities associated with likely alternative developments, estimating impact upon firm's business; and accordingly, take out political risk insurance.
- (7) Act as a good corporate citizen (e.g., export as much as possible, hire and train local nationals, develop and support local suppliers); be especially circumspect and tactful in human resource and public relations practices.<sup>166</sup>

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165. Some early foreign investors who, like General Electric, entered the country before 1990 found disappointing results when their strategy was based mainly on the assumption of quick profits from easy access to COMECON markets and low-priced resources. More recent and successful investors, like Ford, came with a different strategy: to fit their Hungarian plants into a production network, designed from the very beginning to serve Western markets. Tar, *supra* note 44, at 2.

166. Thoughtful behavior and some of the more sophisticated U.S. corporate financing practices may result in substantial benefits to both the firm and the host. See J. Leslie Jankovich, *Western Business and Eastern European Politics: A Case for Business Diplomacy* (Presentation at the Conference for Business Ventures in Central and Eastern Europe: Building Strategic Alliances, sponsored by Virginia Polytechnic Institute and State University and Old Dominion University, Nov. 12-15, 1990, Budapest, Hungary) (on file with author).

*D. A Strategy with Alliances*

*1. Principles*

To help U.S. firms sort out the sequence of issues to be addressed, the elements of their concern—securing a share of the opportunities' upside potential, limiting the downside risk, and allowing gradually increasing commitment in line with experience—can now be arranged in a four-stage model.<sup>167</sup> The model allows for the transfer of a variety of resources such as knowledge, technology and capital, as well as their ownership and control, together with local activities and developments. Each subsequent stage corresponds to a higher profit potential, involves more risk, and calls for more commitment of resources.

*2. Four-Stage Model*

The first stage may be characterized as laying the foundation for the transfer process. Here, the Western supplier is mainly concerned with acquiring information on host country industry and markets, bearing in mind that no market data may be available in terms directly compatible with U.S. marketing practices. At this point, there is a need to establish credentials and develop confidence in the foreign company. Western equipment is delivered, mainly for training locals in operations and updating local engineering know-how. Further, training of local marketing teams starts in product applications, customer-oriented attitudes, market surveying and customer needs appraisal, test marketing, and by using marketing strategies such as segmentation and channel alternatives.

The second stage may well see the local assembly of major components and subassemblies with Western components, documentation, and engineering. The Western party may encourage its own suppliers to link up directly with the local firm. Later, a few simpler components are manufactured locally, thereby contributing to the beginning and steady expansion of a supplier network and broadening the industrial base. In the absence of domestic capability, such components may temporarily come from nearby countries if such supply is cheaper or more appropriate for local standards than the original Western source. Concurrently, documentation in the local language emerges; and quality control measures are put in place. The Western firm establishes a reputation as a competent and reliable supplier of technology, expertise, and high-quality components. During this period, a comprehensive marketing strategy is formulated with local, and perhaps, region-wide marketing channels and marketing intelligence evaluated for future product changes. Additionally, a customer service system is set up and sales volume begins to build.

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167. Jankovich, *Cross-National Strategy*, *supra* note 152.

In the third stage, more and more parts of increasing complexity are fabricated locally or within the region until finally, the completed equipment qualifies as a local product. The first locally completed products serve as verification units. Local engineers start further development of equipment in response to market research findings. Thus, market-oriented research and development capability are established in support of intraregion production for local and third-country markets. Full-scale production of first-generation equipment takes place for sale in local and export markets.

The fourth stage is characterized by comprehensive local capabilities established and developed to the level where they can respond in a cost-effective and timely manner to market demand from around the globe, including the domestic markets of the Western partners. The company in the West may, in turn, want to benefit from the lower cost or specialized knowledge and capability of the Eastern facility through outright reexporting of the finished goods or, perhaps, through contract research.

### *3. Coping with Success*

As a result of successful technology transfer, the recipient firm may become a formidable competitor to the donor, perhaps even in the donor's own market. Simply refusing to go ahead with the deal does not necessarily protect the originator of technology from later fierce competition since there are probably other vendors of similar technology ready to step in. Additionally, in time, the eager Hungarian establishment may develop the product and technology on its own.

A better solution for the U.S. donor of technology is to: (1) be prepared for the consequences of success in the transfer by taking appropriate steps in the beginning of the process, for example, drafting and signing a thoughtful long-term agreement with the other party; and (2) continue with incessant upgrading and development of its own technology as the only real safeguard of its distinctive competence. Failure to do both can too easily lead to the upstart company replacing the former technology leader in important markets.<sup>168</sup>

## V. CONCLUSION

### *A. Key Findings*

A unique set of circumstances in Central and Eastern Europe is creating potentially rewarding opportunities for U.S. firms. The associated exposure to

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<sup>168</sup> Key elements of the model, together with the unanticipated consequences of its successful application, were observed firsthand by the author among related corporate entities where the process reached its fourth stage in about seven years from the entity's first initiating contact.

risk, varying from country to country, can be managed to remain within acceptable limits.

In the very heart of the region, and indeed of the entire continent, Hungary offers U.S. business a central foothold with a favorable return-to-risk ratio through access to emerging markets on the spot and beyond, as well as resources for use in Hungary, and even in the United States and elsewhere. Thoughtful assessment of the American firm's global long-term strategy reflecting its distinctive competence on one hand, and what is available in Hungary and the region on the other, may well lead to significant competitive advantage over less open-minded companies.

As with the challenges, the pitfalls are different from those typically encountered in the United States. Both can be handled more effectively by recognizing the underlying forces of change through careful analysis and responding to them in a timely manner.

### *B. Is It for Your Company?*

Taking advantage of the emerging potential while controlling the related risk calls for selectiveness, as well as approaches and forms of involvement different from standard U.S. practice. It will also require a longer time to carry business plans to fruition than usual in established market economies.

Thus, involvement in Hungary, as in the rest of Central and Eastern Europe, is not for the company with a short-term next-quarter bottom-line mentality. For the select few, with a longer time horizon commensurate with more ambition, carefully chosen location and form of involvement in Hungary may well offer a foothold for profitable business expansion in the region and beyond.

To secure the rewards, the firms also need competent professional advice: a point where our distinguished audience comes into the picture and where the matter is confidently left in their hands.

