

The Potential for Joint Ventures in Eastern Europe

My task this afternoon is to give an overview of the potential for "joint ventures" in Eastern Europe. Joint ventures are the most advanced form of East-West co-operation.

In general, the joint venture in Eastern Europe permits direct participation by the Western company in marketing and other operations of the joint enterprise. This role can be more comprehensive than that which would be permitted to the Western partner within the framework of a "co-operation agreement."

Western partners may prefer joint ventures over the more traditional forms of co-operation for various reasons. One potentially important reason is expectation of a greater measure of control over production than would be possible through more traditional industrial co-operation links. A second possible advantage would be a measure of control over management decisions, thus allowing the Western partner more opportunity to protect his worldwide investments and marketing networks. A third potential advantage of the joint venture may be that it allows broader scope for profit-taking, sometimes with lower effective taxes. Still another advantage is the opportunity to obtain direct, first-hand know-how about marketing within Eastern Europe.

Certain Eastern European countries also believe, at least officially, that the joint venture is more advantageous to them, in contrast to the more classical forms of co-operation. Why?

In general, they feel the joint venture approach secures a greater commitment by the Western partner to the success of the joint venture activity, and on a continuing basis. Consequently, they believe they stand a much better chance of having continuing access to the Western partner's technical and managerial know-how. Other obvious potential benefits include the financial contribution of the Western partner, and its assistance in obtaining additional financing elsewhere. In practice, of course, the specific benefits of each case may vary.

So-called joint ventures are now permitted in Yugoslavia, and in two COMECON countries, Romania and Hungary. Each of these countries has enacted special legal provisions for this purpose. In all three countries, it is now

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possible to establish joint ventures that have legal characteristics similar to joint ventures in market economy countries, with co-management, co-ownership of capital, and sharing of profits and risks.

Parenthetically, let me note that the subject of our afternoon discussion is not joint ventures with East European partners in third countries. I fully subscribe to what has been said earlier today, about the possibilities for joint ventures with Eastern partners in third markets. From the lawyer's point of view there is nothing unique about such ventures. They might, for example, involve setting up a joint company in a Western country, or in a developing country.

Yugoslavia, as you probably know, has for some years been moving in the direction of a so-called "Socialist market economy." Through a series of laws dating back to 1967, it has allowed foreign investment in Yugoslavia through what are commonly called "joint ventures." By April 1975 about 110 joint ventures had been registered, with total joint venture investment somewhere near \$800 million. Official statistics are not available since January 1974, possibly because the Yugoslav government is concerned about the low level of foreign investment. Western investment in these joint ventures has tended to average about 17 percent of total equity, and much of this is often in the form of capitalized know-how. Therefore, it seems that relatively little hard currency has flowed into Yugoslavia through the joint ventures, though some very large deals currently under discussion could change that picture.

Within the COMECON area joint ventures are permitted in only two countries—Romania and Hungary. In Romania—despite considerable fanfare and official enthusiasm—there have only been five joint ventures thus far: by West German (1), Japanese (1), French (1), American (1) and Italian (1) companies. Only two of these are operational. Both have had start-up problems. It seems clear that the Romanian experience has not fully matched the high early expectations, perhaps because of the complex questions involved in trying to negotiate and operate a joint venture in that country. Thus far, the Romanian joint venture legislation does not give promise of large scale Western investment in that country.

The available evidence indicates that other East European countries have come to appreciate the limitations of both the Yugoslav and Romanian models.

In the Yugoslav model, the joint venture operates essentially like other Yugoslav enterprises, except that certain special rules apply to joint venture enterprises, particularly with regard to taxation. This approach was made possible because of the evolution of the Yugoslav economy to something approaching a market economy setting, along Western lines.

By contrast, in the Romanian model joint ventures largely operate as "enclaves," outside of the Romanian economy. They operate in an agreed hard currency. This means that most purchases from Romania are in hard currency,

at negotiated prices. Likewise, sales are normally in hard currency. Sales made under Romania's bilateral clearing arrangements, to COMECON countries or to third markets, do not give rise to hard currency for the purpose of remitting profits to a Western partner.

In Hungary only two joint ventures have been concluded by the time of this Institute. The first is with Sweden's Volvo, and the second with Siemens of West Germany. Hungarian joint ventures are not permitted directly to engage in productive operations or manufacturing. In Hungary the joint venture has a more limited basis. It is contemplated mainly for trading, for product servicing, and research and development. Therefore, many of the problems which might arise in connection with Romanian or Yugoslav joint ventures are not encountered, because of the limited role of joint ventures in Hungary.

Poland has had the question of joint venture legislation under study for some time, and until about a year ago the Poles were saying that it was just a matter of time until the legislation was actually enacted. But recent information indicates that there will be no new joint venture legislation in Poland for the foreseeable future. Poland claims that joint ventures are possible under the existing (pre-Socialist) legislation, but no Western company thus far has taken the "plunge" and concluded a joint venture in Poland on that basis.

For the present, the Poles clearly seem to prefer their present policies, which have led to some major projects involving Western partners. A good example is the Massey Ferguson-Perkins deal, a \$355 million industrial co-operation project concluded last year.

Bulgaria seems also to have opted (for the present at least) for the industrial co-operation model. New regulations issued in 1974 give the green light to "industrial co-operation" with Western firms. These regulations even speak of "profits" from co-operation programs; so there is, it seems, some recognition on the Bulgarian side of the need for greater flexibility, but clearly within the co-operation context rather than through joint ventures.

Czechoslovakia seems preoccupied with other concerns, and not interested in permitting joint ventures at this stage. In fact, Czechoslovakia's record of achievements in industrial co-operation with Western firms is very modest, so joint ventures in Czechoslovakia may be a long way off.

East Germany has just begun to conclude industrial co-operation programs with Western firms. For obvious reasons it is unlikely that the GDR will be in the vanguard of East European countries breaking new ground in business relations with the West.

That brings us to the Soviet Union. The Russians have been studying the question of joint ventures for at least the past year. It is difficult to predict how they will finally resolve the matter. This involves mainly practical issues—how to permit "joint ventures" in the U.S.S.R. with Western firms, consistent with

other Soviet policy objectives and the existing pattern of Soviet industrial organization—particularly if the joint ventures would involve a substantial management role for Western companies.

It is difficult to see how those practical issues will be resolved, but legally it is very easy to imagine a scenario for resolving them on a “contract” basis, rather than on a basis of “ownership” rights. No conflict with Soviet constitutional rules need arise.

The texts of the various laws in the three countries that permit joint ventures (Yugoslavia, Romania, Hungary) differ in detail, but have much in common. One common denominator is that the generation of hard currency earnings is an important, if not indispensable, prerequisite to hard currency profit remittances. Thus, a central issue in any joint venture negotiation in these countries is to find a practical way to permit the joint venture to earn hard currency.

Generally, this means that export markets must be anticipated. For many Western companies, this often boils down to a need to find a product line which will not be competitive with its existing plant capability elsewhere.

One fundamental difference between Yugoslavia on the one hand, and Romania and Hungary on the other, is that in Yugoslavia the local partner is not the state. The local partner in Yugoslavia is an enterprise that is socially-owned and controlled by its employees. This has very significant legal and practical consequences.

The Hungarian economy has evolved in a way that perhaps is closer to Yugoslavia than to Romania. Although the local partner in Hungary would be a state-owned enterprise, as in Romania, it is likely that the personnel in Hungarian enterprises might share the Western partner’s outlook to a greater degree than their counterparts in Romania.

In all three countries, the Western partner’s equity share must, in practice, be less than 50 percent. In theory, therefore, the Western partner does not have voting control. However, in all three countries it is possible, through skillful lawyering and negotiating, to provide mechanisms that ensure a substantial measure of control in key areas, and prevent important decisions from being taken without the consent of the Western partner.

It is also worth noting that although in theory the Western partner’s right to share in joint venture “profits” is normally limited to his share of equity capital, there are other opportunities for realising effective profit—management fees, royalty arrangements, pricing of supplies to the joint venture and pricing of purchases from the joint venture, to name only a few obvious possibilities.

There are a number of other joint venture negotiation issues which we haven’t time to go into here, such as personnel matters, taxation, protection of industrial property, customs, creditors’ rights, reinvestment rules, reserve funds, etc. Generally, such issues do not present insuperable barriers, provided

that the business deal itself makes sense and that the parties have solved the basic marketing question, *i. e.*, assuring a source of hard currency earnings for the joint venture.

Difficult practical problems also tend to crop up at the start-up/operational stage. Even the most prescient and prudent Western company may fail to allow for a sufficiently large margin of error. In Yugoslav joint ventures Western partners have often made excessively optimistic calculations about such matters as local costs, start-up time required, etc. Also, in some joint ventures in Yugoslavia, Western partners have sought an "equal say" while taking only a small (*e. g.*, 15-20 percent) equity position. Naturally, such a situation can give rise to problems.

Joint ventures can succeed in Yugoslavia, but this normally requires the full efforts of both sides. There are some success stories, and there have been some disappointments.

If my brief presentation has sounded a bit cautious today, it was out of a desire to emphasize the importance of careful planning before getting too deeply involved. In view of the unique features of these joint ventures, the interested Western partner should make certain it has the benefit of informed advice as to the technical, financial, commercial, legal and other aspects.

