Proposal for a Thesis
in the Field of Government
in Partial Fulfillment of the Requirements for
the Master of Liberal Arts Degree

Harvard University
Extension School
December 17, 1999

Ann K. Holder
88 Deschanel Avenue
Lasker, MA 02414
508-245-9120
akholder@fas.harvard.edu
I. Tentative Title

The proposed title of my thesis is “Achieving Joint Gains in Government-Business Negotiations in Developing Countries: Recent Experience in Central Europe.”

II. Research Problem

My thesis will address the following threefold question: (1) Is it possible to successfully negotiate foreign direct investment (FDI) projects between the national government and multinational corporations (MNCs) in developing countries? (2) Can joint gains be achieved, and (3) What are the conditions necessary to achieve them?

Although major industrial and raw-material enterprises were established on a global level by the end of the nineteenth century, MNCs have only become major players in the world economy since the end of the second World War. National governments in developing countries are interested in attracting MNCs because of their access to capital, technology, information, and managerial skills. Furthermore, developing countries are highly dependent on MNCs for the exploration, processing, shipping, marketing, and distribution of their raw materials. On the other hand, MNCs are interested in tapping the developing countries’ raw materials, low labor costs, and frequently large untouched markets. This suggests that both developing countries and MNCs can gain from foreign direct investment (FDI) projects. Recent evidence, however, suggests that many of these projects have failed or only achieved a modicum of success.¹

The study analyzed FDI in four Central European countries—The Czech Republic, Hungary, Poland, and Slovakia—during 1989-1997. Hungary was the most

successful country, with cumulative FDI inflows of $15.40 billion, followed by Poland ($8.44 billion), The Czech Republic ($7.47 billion) and Slovakia ($912 million). Although there is clearly a flow of FDI into these countries, there is reason for concern as well. That is to say that 962 projects did not materialize because the parties failed to create joint gains in the negotiation phase. These 962 projects combined represented an estimated $28.3 billion.\(^2\)

My hypothesis is that it is not only possible to successfully negotiate foreign direct investment projects between the government and MNCs, but that joint gains can indeed be explored. There are, however, two conditions necessary to achieve this outcome: (1) the presence of a neutral agent to assist the negotiation process, and (2) the willingness of the parties involved to reveal confidential information and their respective reservation values to the neutral agent to develop the negotiation template.

The evidence used to test my hypothesis will be drawn from primary source documents from the relevant government sources and agencies (e.g., CzechInvest, ITD Hungary,\(^3\) statistical offices) and the MNC concerning a recently proposed project in Central Europe. Additionally, the negotiations literature will be consulted to provide the context for this study.

My anticipated conclusion is that joint gains in government-business, or public-private, negotiations can be achieved through the introduction of a neutral agent and the creation of a negotiation template. Modeling information from an actual FDI project using a negotiation template as the link between the different investment valuation techniques (i.e., DCF/NPV and ECBA) can assist the neutral agent in facilitating the negotiations, and as such help to overcome the strategic barrier to negotiations. Thus, the


\(^3\) Hungarian Investment and Trade Development Agency.
parties will tend to move more easily from a value claiming to a value-creating mode. This will improve the outcome of the negotiation, thereby meeting the efficiency and fairness criteria.

My objective is to share my findings with the International Finance Corporation of the World Bank and the European Bank for Reconstruction and Development, as they are frequently consulted by both developing country governments and MNCs regarding foreign direct investment projects.

III.

Definition of Terms

“BATNA”: Best Alternative To a Negotiated Agreement. This term was first introduced by Fisher [1981] and has been widely accepted among scholars in negotiation. It is often referred to as the “walkaway” value or price, or “reservation value.”

“Cost of capital”: The cost, measured as a percentage rate, of the various sources of capital required to finance capital expenditures. All sources of capital have a cost that can be a direct one as, for example, with a loan or an opportunity cost such as with retained earnings. At any time a company’s cost of capital will be the weighted average of the cost of each type of capital. The weight is determined by the ratio of the value of each type to the total value of reserves and all securities issued by the company.

“Developed country”: A country in which real national income per capita is relatively high and that enjoys a relatively high standard of living.
“Discount rate”: The rate at which future benefits and costs are discounted. It is the opportunity cost of capital and can be estimated as the weighted average of the real costs of interest of the various alternative sources of capital.

“Economic Cost-Benefit Analysis (ECBA)”: A conceptual framework for the evaluation of investment projects in the government sector. It differs from a straightforward financial appraisal in that it considers all gains (benefits) and losses (costs) regardless of to whom they accrue (although usually confined to the inhabitants of a nation). A benefit is then any gain in utility and a cost is any loss of utility as measured by the opportunity cost of the project in question. Strictly pursued, ECBA would value all inputs and outputs at their shadow prices.

“Foreign Direct Investment (FDI)”: This usually refers to any investment in another country that is carried out by private companies or individuals as opposed to government aid.

“Gross Domestic Product (GDP)”: The value of all goods and services produced in the economy in a given period. GDP is the basic measure of the total output of goods and services in the economy.

“Gross National Product (GNP)”: GNP measures the total income earned by domestic citizens regardless of the country in which their factor services were supplied. GNP equals GDP plus net property income from abroad.
“Hurdle rate”: The minimum acceptable rate of return from an investment project. Public and private hurdle rates are not necessarily equal. Empirical studies have indicated that private hurdle rates tend to be higher than the public hurdle rate (i.e., the opportunity cost of capital).

“Internal Rate of Return (IRR)”: The discount rate that equates the present value of cash flows from a project with the present value of the net investment. It is the discount rate that gives the project a net present value equal to zero. The IRR is used to evaluate, rank, and select from among various investment projects.

“Less developed country (LDC)”: A country with low real national income per capita, a large agricultural sector, high population growth, a low capital-labor ratio and poor infrastructure. For example, India or Tanzania. An attempt to quantify the definition is in terms of those countries with per-capita income below one-fifth of that of the US.

“Net Present Value (NPV)”: The net present value of an investment made by a firm is the present value of the stream of net (operating) cash flows from the project minus the project’s net investment; the contribution of an investment to shareholder wealth. A project is acceptable if the NPV is greater than zero. The NPV rule is the primary decision-making rule throughout the process of financial management. Also known as the discounted cash flow (DCF) technique, NPV/DCF is used to evaluate, rank and select among various investment projects.

“Negotiator’s dilemma”: A tension between creating and claiming, or equivalently, a tension between revealing and concealing/misrepresenting information.
“Neutral agent”: Also called an “Intervenor” in the negotiations literature. An individual or group who is called in by the negotiating parties or imposed by some external authority to facilitate reaching agreement. This study will assume that the agent is neutral with respect to the issues being negotiated and to the parties’ interests.

“Opportunity cost”: The opportunity cost of an action is the value of the foregone alternative action. An opportunity cost can only arise in a world where the resources available to meet wants are limited so that all wants cannot be satisfied. If resources were limitless then no action would be at the expense of any other – all could be undertaken – and the opportunity cost of any single action, the value of the “next best alternative,” would be zero.

“Pareto Optimal Frontier”: Also known as the efficient frontier and is defined as the locus of achievable joint evaluations from which no joint gains are possible. The evaluations of the set of those possible agreements on the issues that could not be improved on from the standpoint of either party without harming the other. To determine the efficient frontier, information is required from all parties involved. As such, it cannot be computed by any of the players acting alone. For a situation to be described as “Pareto efficient” it must be impossible to make someone better off without making someone else worse off.
“Prisoner’s Dilemma”: A game that allows the players to achieve mutual gains from cooperation, but it also allows for the possibility that one player will exploit the other, or the possibility that neither will cooperate.4

“Shadow price”: Refers to an artificial or estimated price used in economic cost-benefit analysis to reflect the “true” social costs and benefits of a project.

“Zone of Possible Agreement (ZOPA)”: A necessary condition for an agreement is that it serve all parties’ interests better than their BATNAs. The range of such agreements is the ZOPA.

IV.

Background to the Problem

Industrialization in the developing countries of Eastern Europe, Asia, and Latin America is evolving rapidly. With over 2 billion people living in China and India alone, many Western manufacturers are rushing in to take advantage of this enormous potential consumer market. For example, while the United States comprises about 5% of the world’s population, 95% of the world’s consumers live beyond its borders.5 More than 40% of US exports go to developing countries. At the same time, developing countries are transforming their economies from one based on import-substitution to one based on export-promotion.

Multinational corporations (MNCs) have become increasingly important as they carry capital, technology, and knowledge about processes (e.g., production, decision-

---


making) that are valuable resources for many developing countries. In effect, MNCs can be seen as transmission belts of sorts. As such, developing countries must frequently work collaboratively with MNCs in their quest to achieve the higher living standards of the developed Western economies. Governments often need the resources provided by businesses in order to help attain their social welfare developmental goals. Foreign direct investment (FDI) in the form of joint ventures, acquisitions, and new businesses—greenfields—offers access to capital that might otherwise be unavailable.

In addition to the inflow of capital, FDI has beneficial effects that are particularly important during the initial stages of the transition process. For example, access to modern technology, worker training, managerial expertise, and accounting practices, as well as access to foreign markets are all valuable to developing country governments. As such, many consider multinational corporations to be one of the most important institutions of interdependence in world trade. In the host country, FDI projects can help to raise living standards and provide employment for those displaced by the migration of older activities to other countries.

There are also strong arguments against FDI in developing countries. Those against FDI contend that it constitutes a new form of imperialism and are concerned that MNCs will pursue political as well as economic goals. One of the most spectacular examples of what made developing countries wary of FDI was the political influence exercised by International Telephone and Telegraph (ITT) through its subsidiary in Chile during the 1970s when the Allende regime was in power. Such an event adds to the fears that MNCs will influence politics and prevent the host country from following its preferred path. In addition to the autonomy argument, there are also concerns about the

---

6 In brief, ITT was worried about FDI in Chile when Salvador Allende was elected on a “nationalization” platform. Thus, ITT campaigned against Allende and, once he was elected, funded opposition groups and collaborated with the CIA to oust Allende.
use of inappropriate technology, the repatriation of profits to the home country, and the belief that MNCs exacerbate the already unequal distribution of wealth in developing countries.

The history of foreign direct investment has been characterized by periods of conflict. In the 1950s and especially in the 1960s and early 1970s, large numbers of foreign-owned investments were nationalized in developing countries. Particularly hard hit were investors in plantations, public utilities, mining, and petroleum. Many other foreign investors were forced to take on local partners in their overseas subsidiaries through joint ventures. Some investors, such as IBM in India, elected to withdraw rather than share ownership.

However, since the debt crisis of the 1980s, developing countries have turned increasingly to foreign direct investment to develop their economies. FDI inflows in Central Europe,\(^7\) for example, have increased dramatically since the breakdown of the “iron curtain.” Hungary, Poland, and the Czech Republic have been especially successful in attracting FDI as shown in the table below.

<table>
<thead>
<tr>
<th>Foreign Direct Investment (Smillions)</th>
<th>1990</th>
<th>1995</th>
<th>CAGR</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>(%)</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>207</td>
<td>7,568</td>
<td>65.5%</td>
</tr>
<tr>
<td>Hungary</td>
<td>0</td>
<td>4,519</td>
<td>N/A</td>
</tr>
<tr>
<td>Poland</td>
<td>89</td>
<td>3,659</td>
<td>110%</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>0</td>
<td>183</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>296</td>
<td>10,929</td>
<td></td>
</tr>
</tbody>
</table>


\(^7\) Defined as the Czech Republic, Hungary, Poland, and the Slovak Republic.
Central European countries have also created regional development agencies, frequently with offices abroad, to promote their countries. Considering the statistics, this has proven to be quite successful in most cases.

A recent study conducted by Van de Putte [1998] analyzed FDI in four Central European countries over the period 1989-1997. The Czech Republic and Hungary were especially successful in attracting FDI. Surprisingly, the report revealed that, although there was dramatic growth in FDI in Central Europe, many projects have failed or only achieved a modicum of success. More importantly, 962 projects did not materialize because the parties failed to create joint gains in the negotiation phase.

Negotiation can be metaphorically compared to making a pie and then dividing it up amongst the interested parties. The process of conflict resolution affects both the size of the pie, and who gets what slice. Historically, negotiations between national governments in developing countries and MNCs in evaluating investment projects have not met the criteria of “good” agreements. The main objective of any negotiation is to get an agreement that is better than the parties’ respective BATNAs, or best alternative to a negotiated agreement(s). The expectation of achieving this objective is what should basically bring parties together at the negotiation table. However, once the parties have decided to negotiate, they are usually not satisfied with getting an agreement that simply represents an improvement over their BATNAs but usually expect the agreement to show some additional desirable characteristics.

One of the key objectives of this study is to be able to determine a good or attractive agreement in a government-business negotiation. Several scholars in negotiation have attempted to identify the characteristics of a “good” agreement. For example, Lawrence Susskind and Jeffrey L. Cruikshank’s *Breaking the Impasse*
considers four characteristics: efficiency, fairness, wisdom, and stability. Among those characteristics usually mentioned, two of them are critical: fairness and efficiency.

Fairness is a very subjective perception. Thus, it is important that the neutral agent determines early on what the negotiating parties would consider fair. There are some analytical schemes that determine contracts considered as fair. Most of them have been developed in research on bargaining theory. An agreement is said to be “efficient” when it becomes impossible to determine another agreement that all the parties consider at least equally valuable while it is strictly better for some of them. When an agreement is inefficient this means that there is room for improvement for some parties without jeopardizing the rest. Therefore, when a negotiation results in an inefficient agreement part of the available value is wasted. Typically, government-MNC negotiations in Central Europe have not met these two criteria.8

The underlying reason for this is that every negotiation characteristically involves a tension between: (a) discovering shared interests and maximizing joint gains (efficiency), and (b) maximizing one’s own gains where more for one side will necessarily mean less for the other (fairness). In Why Negotiations Fail: An Exploration of Barriers to the Resolution of Conflict, legal scholar Robert H. Mnookin refers to this barrier to successful negotiation as the “strategic barrier.”9 The failure to overcome this barrier means that many potential good agreements have not been realized. Often, what is good for the government is not necessarily good for the MNC, and visa versa.

---

8 This was the conclusion of a study of regional development agencies, multinational corporations and development banks conducted by Plant Location International, a subsidiary of Pricewaterhouse Coopers, to explore how to increase the effectiveness of regional development agencies in Central Europe. (The study is unpublished).

As in mediated negotiations, where parties reveal information in confidence to an intermediary, it is crucial that some degree of cooperation exists in terms of the clarification of interests and issues in order to obtain joint improvement. In most negotiations, the process of claiming and creating value are in tension since they purport contradictory actions with respect to the management of information. “Value creators” consider the essence of negotiating as expanding the pie, as pursuing joint gains. For them, the process is characterized by openness, clear communication, sharing information, creativity, an attitude of joint problem solving, and cultivating common interests. Conversely, “value claimers” tend to consider this drive for joint gains as naïve and weak-minded. For them, negotiation is characterized by hard, tough bargaining. This tension between creating and claiming value drives the negotiators into a dilemma known as the “negotiator’s dilemma.”

Assume that the parties coincide in being selfish and uncooperative from the beginning, centering themselves in claiming as much value as possible. In this case, they are bound to reach an agreement – if any – that is perhaps fair but will very likely be extremely inefficient since they lack the information to create joint gains. Consequently, they will conceivably achieve an agreement that can be described as “mediocre” for each party involved.

On the other hand, consider now that all parties decide to be cooperative and to candidly share information while focusing their activity on value creation. Here, except for minor deviations of fairness, it could probably be said that they will obtain a “good” agreement. However, imagine that in this all-cooperative situation one of the parties decided to take advantage of the information being provided and resolved to distort its

---

10 For a detailed account of the tensions between claiming and creating value and the subsequent negotiator’s dilemma, see David Lax and James Sebenius, *The Manager as Negotiator: Bargaining for Cooperation and Competitive Gain* (New York: Free Press, 1986).
interests so that it could claim more value. The more this party knows about the others, the more credible and extensive it can make its misrepresentations. This party, which has turned from a creator to claimer, will very likely obtain a “great” (i.e., better than “good”) agreement, while the remaining parties will achieve a bad (i.e., worse than “mediocre”) agreement.

Therefore, it is to the advantage of any party to act as a claimer while the other parties are trying to create value. This conclusion can be reached individually by each of the parties. Consequently, it is in their best interest to behave selfishly and try to claim value.\(^{11}\) As Robert Axelrod notes in *The Evolution of Cooperation*, the problem is that, while an individual can benefit from mutual cooperation, each one can also do even better by exploiting the cooperative efforts of others.\(^{12}\) This idea is also applicable to organizations such as MNCs and governments. However, if all parties claim value, they will get a “mediocre” agreement. This is the dilemma that negotiators face: their best alternative takes them to a poor scenario.

V.

Research Methods

My research methods will include an analysis of primary source documents specific to the government-MNC project of interest (e.g., financial and economic data). Research of secondary sources will include an evaluation and analysis of opinions and current thinking in negotiations literature as it relates to the proposed topic. I will introduce the dependence of developing countries on MNCs in order to develop their economies. The bargaining power of both the national government in the developing

\(^{11}\) In other words, this is an account on the \(n\)-person Prisoner’s Dilemma.

\(^{12}\) Axelrod, 92.
country and the MNC will be analyzed in more detail. More specifically, I will focus my research on how to overcome the strategic barrier to successful negotiation in order to explore joint gains and to meet the *fairness* and *efficiency* criteria of good agreements.

Also, I will briefly study the valuation methods used by both governments and MNCs in considering foreign direct investments—Economic Cost-Benefit Analysis (ECBA) and NPV (or DCF) analysis, respectively. Specific attention will be given to the fact that not only are these methods different, but that what is good for the national government is not necessarily good for the MNC, and visa versa. At this point, I will develop a conceptual framework identifying possible points of congruency or disjuncture between the economic return to the country and the financial return to the MNC. Understanding areas of congruency and disjuncture will be of particular importance during the actual negotiation.

The final part will develop the methodology used to determine efficient and fair agreements in the context of government-business negotiations. I will develop an Excel spreadsheet model to assist the neutral agent in the negotiation process. In order to validate this research, I will then apply the methodology to a series of actual cases: three investment projects in Central Europe. These investments projects have recently taken place in Central Europe and shared similar objectives: (1) to establish a low-cost manufacturing base for Western Europe; (2) to have access to the local markets (i.e., Poland, The Czech Republic, Hungary, and Slovakia); and (3) to have an option to expand into Eastern Europe once the market would expand enough to make it worthwhile. None of the projects materialized, and they were all halted in the negotiation phase because the parties involved failed to create joint gains. This is what makes these cases so interesting for this thesis. I will illustrate why these projects failed to meet the efficiency and fairness criteria, and show that it was indeed possible to create joint gains.
and make it worthwhile for both the respective MNCs and the government. It is interesting to note that all three companies have a strong international presence and are world leaders in their respective fields. All three investment initiatives occurred around the same time and all three MNCs selected The Czech Republic as the final candidate country because of a number of qualitative (e.g., overall business environment, availability of qualified labor, infrastructure and communications) and quantitative reasons (e.g., labor cost, utility and transportation costs, construction cost, import/export duties, and corporate taxation/depreciation). These three investment projects can be briefly described as follows:

Bekaert (Belgium): Bekaert is the world’s leading independent producer and marketeer of high-grade steel cord, steel wire and merchant products (fences). Bekaert also produces advanced materials. The firm’s market and technological leadership is based on its core skills, namely metal-forming and a wide range of coating technologies. Founded by Leo Leander Bekaert in 1880, Bekaert has grown from a small manufacturing and trading company into a global group with its head office in Belgium. The Bekaert group consists of several business units, each addressing a number of market segments. The main business units are Wire, Merchant Products, Steel Cord and Bekaert Advanced Materials.

In early 1999, Bekaert decided to investigate whether establishing a Central European Steel Cord manufacturing facility for rubber reinforcements, such as tires, would make sense. Four countries were proposed for the investigation: The Czech Republic, Poland, Hungary and Slovakia.

Sony (Japan): Sony is one of the largest consumer electronics manufacturers in the world. At the end of 1998, Sony TV Europe decided to investigate whether
establishing a Central European CTV\textsuperscript{13} and picture tube manufacturing facility would make sense from both an operating and financial point of view. Five countries have been proposed for the investigation: Eastern Germany, The Czech Republic, Poland, Hungary and Slovakia. It was intended that the facility would be operating in the year 2000 and that full capacity would be reached within a few years of operation. It was also planned that the facility would employ approximately 2,000 people and produce in excess of 2 million CTVs and picture tubes, making it the largest facility in the world of its kind.

Parker Hannifin (USA): Parker Hannifin is the world leader in motion and control technologies, providing systematic, precision-engineered solutions for a variety of commercial, industrial and aerospace markets. Parker Hannifin is a strategically diversified global company, which has grown through a combination of organic growth and acquisitions.

In March 1999, Parker Hannifin decided to develop an incubator facility at a low cost location in Europe. The Czech Republic, Hungary, Poland and Slovakia were selected as candidate countries, based on the following characteristics: (1) low cost European location, (2) stable economic and political environment, (3) geographic and logistical position to the main European markets, and (4) sizable economy and industrial base.

The source materials used to test this hypothesis will include reports on macro-economic data (e.g., GDP, unemployment, inflation, foreign direct investment flows, exchange rates) and micro-economic data (labor costs, production costs, incentive schemes) from government development agencies (e.g., CzechInvest, Hungarian Investment and Trade Development Office) and the MNC (e.g., market volume, production costs, cost of capital).

\textsuperscript{13} An abbreviation for the cathode television technology used in electronics production.
VI.

Research Limitations

Although the field of negotiations is a relative young “academic” discipline, a wide variety of publications are already available. However, as negotiations are used in a variety of situations, publications are frequently applied to the author’s specific area of interest (i.e., government, economics, law, or business situations). Therefore, I purposely limit my research to the negotiation between two parties: (1) the national government of a developing country, and (2) a multinational corporation. The negotiations concern potential direct foreign investments by MNCs in developing countries. Furthermore, I will assume that a neutral agent will assist the negotiation process, and that this agent is truly neutral with respect to the issues being negotiated and to the parties’ interests. Finally, I will assume that the neutral agent has full access to the information private to each party, but that the respective parties have no access to the other party’s information.

VII.

Tentative Schedule

Initial submission of proposal...............................................................November 5, 1999
Proposal returned for revisions............................................................December 3, 1999
Submission of second draft of proposal..............................................December 17, 1999
Proposal accepted by research advisor..............................................January 2, 2000
Thesis director agrees to serve.............................................................February 15, 2000
First draft of key chapters completed..................................................June 9, 2000
Thesis director returns corrected first draft...........................................July 7, 2000
Revised draft completed.................................................................August 4, 2000
Thesis director returns revised draft.....................................................August 18, 2000
Final text submitted to thesis director & research advisor.................September 15, 2000
Final text approved............................................................................September 30, 2000
Bound copy of thesis delivered to Extension.......................................October 31, 2000
VIII.
Working Bibliography

Works Cited


Works Consulted


Works to Be Consulted


