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Privatization in Hungary: A Stocktaking of Economic Reform

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PRIVATIZATION IN HUNGARY: A STOCKTAKING OF ECONOMIC REFORM

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ABSTRACT

Following the political changes in early 1990, Hungary was positioned to push ahead with economic reform. During the final years of communist government, Hungary implemented key laws which provided a framework to undertake the subsequent massive economic transformation.

During the summer of 1994, one of the authors had an opportunity to do some marketing strategy development work for the United States Information Service in Budapest, Hungary. This paper deals with the economic, political, and commercial aspects of the privatization process in Hungary.

INTRODUCTION

In the four years following the overthrow of communism in 1989-1990, the countries of Eastern Europe experienced a prolonged and savage fall in output. Unemployment climbed; in Hungary it reached 13 percent in 1993. Measured real wages fell dramatically. Privatization of outdated monopolies employing whole regions proved extremely difficult. On top of all that came the collapse of COMECON, the trading arm of the Warsaw Pact, which in 1989 had taken 70-80 percent of many countries' exports. With all this said, economic transformation has gone further and faster than most people realize. This article looks at privatization in one progressive Eastern European country, Hungary.

The Hungarian States Holding Company, the strategic arm of the country's efforts to privatize, intends to hold onto telecommunications, banking and utilities while the State Property Agency (SPA) continues down the road toward expanding a now vibrant private sector. The SPA strategy has been to first sell off big stakes to large well known investors, who could restructure and manage the company, and then offer additional shares on the stock market, in hopes of enabling Hungarian financial investors to participate in these companies' ownership. For the country this strategy has proved to be a huge success. However, increased government debt has dimmed an otherwise optimistic outlook for Hungary in the near future. Hungary's budget deficit was supposed to be 70 billion forints ($9 billion) in 1992. It turned out to be 190 billion. Of the 120 billion shortfall, 100 billion was accounted for by unexpectedly low taxes on company and banking profits.

PRIVATIZATION IN HUNGARY

Following the political changes in early 1990, Hungary was positioned to push ahead with economic reform. During the final years of communist government, Hungary implemented key laws which provided a framework to undertake the subsequent (massive) economic transformation. Hungary quickly took the lead in creating a commercially-friendly environment and attracting foreign investor interest.

Yet, problems have surfaced and the transition has not been painless. The economy remains sluggish--real GDP declined and unemployment increased. With respect to privatization, some observers assert that the process has stalled. These observers, in turn, are wondering whether Hungary is less attractive vis-a-vis other countries in the region.

Few regional observers refrain from making comparisons between Hungary, the Czech Republic and Poland; this temptation may not be particularly useful. The three economies are as different as the cultures, and the governments have chosen varying approaches to economic reform. As a result, these countries stand at differing points on the rather steep "learning curve". Progress achieved by one country should not be interpreted as failure on the part of the other two countries.

The magnitude of the economic transformation--and ramifications--is often glossed over. Given the enormity of the task and the lack of precedence, problems <u>cannot</u> be avoided. The Government of Hungary has demonstrated that it can respond to and manage the problems as they arise. Hungary is building an economy which nurtures private enterprise and continues to attract foreign investment. In 1993, the United States was still the leading investor, accounting for 40 percent of the $5 billion worth of total foreign direct investment.

POLITICAL FACTORS

Nearing the completion of its four-year term, Hungary's first freely-elected government in more than 40 years can look back upon some significant achievements. But tough challenges are still ahead. Efforts to create and consolidate democratic institutions and develop a market economy have been accompanied by a declining economic situation which, not unexpectedly, has contributed to public dissatisfaction and an increasing polarization of society.

Fears that irresponsible elements would exploit these dissatisfactions for their own ends sparked one of the government's biggest crisis since the change of regime--a debate that dragged on for more than six months while Prime Minister Antall's Hungarian Democratic Forum (MDF) party debated how to deal with the party vice president who was promoting highly nationalistic and racist views. With the departure of several party members in June 1993, the crisis ended. But the debate diverted attention from other important issues, with the result that the party--and the government--have weakened.

Despite these strains, Hungary's multi-party democracy has proved itself the most stable in the region. The governing coalition consists of three center-right parties, which in 1990 won more than 60 percent of the parliamentary seats. The largest opposition party, the Alliance of Free Democrats, holds less than 25 percent of the seats. Two other parties, FIDESZ (Young Democrats) and the Hungarian Socialist Party (MSZP), are also in the opposition. After the May 29, 1994 elections, the Hungarian Socialist Party (MSZP) unseated The Hungarian Democratic Forum. (See exhibit one.)

In moving to restructure Hungary's entire political and economic systems, Parliament has passed more than 100 major laws since 1990. Among the more significant laws are: constitutional reform, compensation, bankruptcy, concessions, court reform, labor code and local government reform. Despite this impressive record, many key issues still await action. Since some of these laws require a two-thirds majority, their passage appears unlikely before the next elections which are scheduled for the Spring 1994.

ECONOMIC FACTORS

While the economic transitions got off to a brisk and optimistic pace, the situation has become more complex.

The Central Statistical Agency reports that in 1992 real GDP dropped by an estimated 5 percent for the 5th consecutive year. The drop in national output is attributed to the weakened domestic demand component and the still lingering affects of the collapse of the former COMECON (the trading arm of the Warsaw Pact) markets. Industries particularly hard hit are the heavy industrial sector (e.g., mining and metallurgy), chemical and consumer products. The agricultural sector again suffered a severe drought which slightly lowered output and exports.

Yet, official statistics belie actual economic activity and performance. For example, the private sector is believed to account for nearly 40 percent of GDP. Smaller companies are often overlooked by official surveying methods or may under report their activity in order to escape the heavy tax burden. The size of the "blackmarket" is believed to be as high as 20 percent of GDP. Consequently, official statistics probably overestimate the drop in real GDP.

The free-fall of the economy is not expected to stop until 1995 with GDP expanding incrementally. Unemployment is largely structural; further progress in privatization will result in not only the redistribution of workers, but re-absorption of the unemployed into the active workforce. Unemployment is expected to peak in 1993 at an estimated 15 percent. The Government's strict monetary policy has succeeded in significantly reducing inflationary pressures.

In 1992, inflation dropped--from the 1991 peak rate of 35 percent--to 22 percent. The

Government's adherence to a "tight" monetary policy will continue. By the end of 1994, inflation could be approaching single digits.

In the external accounts, Hungary has registered balance of trade surpluses since the late 1980s. In 1992, Hungary's exports grew 7.4 percent while imports were static (in terms of volume, a 3 percent drop). During the first quarter in 1993, however, Hungarian exports decreased by 27 percent (compared to the same period in 1992), placing the current account in deficit by $200 million. This trend has raised concerns that Hungary's export performance will further deteriorate in 1993. A 25 percent drop in exports could result in a 4 percent decline in the real GDP.

COMMERCIAL FACTORS

Foreign Investment & Privatization

In the late 1980s, the Government of Hungary promulgated a series of laws which prepared the country for the massive privatization that began shortly thereafter: the Companies Act, the Transformation Act and the Investment Act for Foreigners. These laws described how state-owned enterprises could transform themselves into share companies, defined the legal form and extended generous tax incentives and national treatment to foreign investors. The laws were critical to establishing a framework in which to conduct the massive privatization of the economy and simultaneously encourage and facilitate the much-needed inflow of foreign capital.

In 1990, the State Property Agency (SPA) was formed to oversee the sale of state assets. Pursuant to the Act which created the SPA, all sales were to be conducted through a tendering process. Hungary immediately forged ahead with the formal and informal privatization programs. However, 3 years later the results fall short of what was hoped. The First and Second (formal) Privatization programs were failures; only a handful of companies were privatized. It is estimated that 18 percent of assets owned by the state in 1990 have been privatized. In 1992, 602 of 1,850 companies were transformed into shareholding companies, the first step in the privatization process. The state has reduced its ownership to less than 50 percent in only 125 companies and maintains majority ownership in another 275 companies.

The SPA introduced new programs to jump-start privatization. In October 1991, the Decentralized Privatization Program permitted medium-size companies to select advisers to guide them through the process. The Program devised incentives for the advisers to expedite the process. Given the success of the first program, a Second Decentralized Privatization Program was initiated in the Spring of 1992.

The Government has vacillated over the pace of privatization. Underlying this reaction is the apprehension that state-owned assets will be acquired at "bargain basement" prices by foreign investors. In June 1992, Parliament promulgated a list of 164 companies in which the Government will maintain some form of interest. The list includes: the Hungarian Telecommunications Company (MATAV), MALEV (Hungarian airlines), MOL (the Hungarian Oil & Gas Co.), pharmaceutical companies, utilities and state farms. In August 1992, the Parliament created the Hungarian State

Assets Handling Agency (HSHA) whose portfolio consists of the 164 companies. It is currently called the Hungarian State Holding Company.

The Government has developed new instruments to stimulate Hungarian participation in privatization. Of the estimated 18 percent of privatized assets, nearly 70 percent has been purchased by foreign investors. Foreign investor interest is expected to diminish as the remaining stock of companies becomes less attractive. Hungarian participation, then, becomes critical to bring the privatization process to a successful conclusion. The shortage of capital in Hungary effectively blunts efforts by Hungarian companies to participate. The Government has opened lines of credit ("E-loans"), initiated leasing options and encouraged employee buy-outs. The Government is also reviewing a proposal for mass privatization which would involve the issuance of coupons tied to shares in designated state enterprises.

In mid-1993, total foreign direct investment in Hungary was estimated to be $5.3 billion. The U.S. accounts for an estimated $2.5 billion. Major American investors include: ALCOA, American Express, Columbia Chemicals, Ford, GE, GM, Guardian Glass, Pepsi, Philip Morris, Proctor & Gamble, RJR, Sara Lee, United Technologies, US West, etc. Besides the U.S., Germany has also invested substantial capital in Hungary. In April 1993, Volkswagen announced plans for an assembly plant in northwestern Hungary; initial investment is DM 350 million with potential for an additional DM 600 million.

On the whole, American companies are satisfied with the performance of their investments. The Embassy has received complaints from potential investors about the State Property Agency. Specifically: (l) little or no flow of information; (2) conflicting information from various levels within the organization; (3) failure to specify tendering criterion; (4) lack of transparency in the process.

Tax Structure

The corporate (or "Entrepreneurial Profit") tax rate is 38 percent. Pursuant to the 1988 Investment Act for Foreigners, tax abatements are available, but these allowances are set to expire on December 31, 1993.

Companies that are in operation by the date of expiration will have their benefits "grandfathered." It is not certain whether the Government will offer new tax incentives in the future.

Hungary's personal income tax rates vary between 12-44 percent. Hungarians (resident in the country at least 183 days) are taxed on worldwide income; non-residents are taxed solely on Hungarian-sourced income. The United States has a tax treaty with Hungary which prevents double taxation.

In 1980, Parliament enacted legislation empowering local councils to levy and to collect certain property taxes and to tax turnover and employee numbers of small businesses. While local councils have not utilized this authority, local taxation is likely to increase substantially in the future.

Hungary has a national social insurance system which covers all Hungarian workers. The employer is required to contribute 44 percent of the employee's gross wage to the system; the employee must contribute an additional 10 percent of his/her wages. This allows for high levels of social spending by international standards. Nearly three-quarters of government spending goes to unemployment, health, education, and pensions.

Hungary maintains a value-added tax (VAT). As of August 1, 1993, the VAT has been restructured. The 0 percent and 6 percent categories have been eliminated. A two-tier system with rates of 10 and 25 percent will remain. Electricity, natural gas and water for households, which previously were not subject to VAT, will now be subject to 10 percent. Medicines will not be subject to VAT until the end of 1994.

Excise taxes are applied to gasoline, alcohol and tobacco. Gasoline accounts for nearly 70 percent of excise revenues. In 1992, gasoline became subject to a 25 percent VAT; excise taxes on gasoline have dropped substantially.

Property Ownership

Companies with foreign ownership may buy and own property (including buildings, warehouses, factories, retail outlets, capital equipment and land) for conducting business. No property acquisition is permitted for speculative purposes, although this may change if certain proposed amendments to the land laws are adopted. State-owned property must be acquired with the approval of Executive Committees, and city and county councils. Securing ownership is not an automatic process. If actual ownership is denied, long-term property usage rights may nevertheless be obtained.

External Relations
United States:

In 1992, two major decisions by the U.S. Government removed obstacles to U.S. Hungarian trade relations. While Hungary has enjoyed Most Favored Nation (MFN) treatment since 1978, MFN status was subject to an annual renewal. In April, Hungary was "graduated" from Title IV ("Jackson-Vanik" Amendment) of the Trade Act of 1974, extending to Hungary permanent MFN status. In May, Hungary was removed from COCOM's list of proscribed destinations, enabling Hungary to receive formerly-restricted high tech equipment which is vital to developmental efforts.

Since 1990, Hungary has been designated a "Beneficiary Developing Country" under the U.S. Generalized System of Preferences (GSP) Program. Eligible products enter the United States duty-free. Approximately 50 percent of Hungarian exports to the United States are covered by GSP. In 1992, U.S. imports from Hungary fell $19.5 million compared to the previous year. In the first quarter of 1993, imports have declined by 5.5 percent.

In 1992, U.S. exports to Hungary climbed to $282 million--14.2 percent higher than in 1991. Preliminary statistics indicate that U.S. exports have increased 37.5 percent between January-March 1993 compared to the same period in 1992. In terms of investment, the U.S. is the leading supplier of capital to Hungary, accounting for an estimated $2.5 billion (or approximately 40 percent). In 1993, USFCS/Budapest compiled "The Directory of U.S. Investors in Hungary;" this publication is available upon request.

The United States continues to negotiate a comprehensive Business and Economic Treaty (BET). Controversial issues tackled within the negotiations include Intellectual Property Rights (IPR).

Through the "1989 Support for East European Democracy ("SEED") Act", the United States channels economic assistance monies to Hungary for: structural adjustment; private sector development; trade and investment; and, educational, cultural and scientific activities. Most of this assistance is provided as grants, not loans, under the auspices of the U.S. Agency for International Development (AID).

The European Union:

Hungary has succeeded in reorienting its trade with the West. In particular, ties between Hungary and the European Union continue to intensify. In 1991, Hungary signed an Association Agreement with the EU which will result in the asymmetrical reduction of tariffs over a 5-year period, the reduction of quotas in textiles and agriculture, and the harmonization of Hungary's institutions with those of the EU. In June 1993, EU promised the acceleration of the market access provisions. Hungary views the EU as a strategic partner and hopes to attain full membership by the year 2000. But as Mr. William Lewis Baltimore, III, Counselor of the United States of America Embassy in Hungary, stated in an interview, "We'll just have to wait and see. There are a lot of variables at work."

Already, the EU has become Hungary's largest trading partner, accounting for nearly 50 percent of trade in 1992. Within the Union, Germany is Hungary's leading trade partner. Yet, Hungary may be learning some difficult lessons in the evolving relationship with the EU. In April 1993, the EU slapped a ban on imported meat originating from the former COMECON countries (including Hungary) after hoof-and-mouth disease was discovered in meat supplied from Croatia. Brussel's broad "knee-jerk" reaction was viewed as discriminatory by Budapest. Earlier in 1993 at the East European Conference hosted by Denmark (the then incumbent of the EU Presidency), Hungary's Foreign Minister was openly critical of the EU reaction and their general lack of commitment to open markets to products exported from Eastern Europe.

Central Free Trade Agreement:

In December 1992, Czechoslovakia, Hungary and Poland completed negotiations on the creation of a free trade area. Modeled after the structure of the Association Accords, this agreement will reduce trade barriers over an 8-year period; duties on 15-30 percent of mutual trade were eliminated immediately upon implementation of the Agreement in March 1993. Notwithstanding this accord, trade liberalization should be an even higher priority for the "Visegrad countries" in order to galvanize commerce between the nations. Successful completion of a free trade area may become a prerequisite for full membership in the EU. Hungary is weighing free trade agreements with Slovenia and Croatia.

Foreign Trade Regulations

The decentralization of foreign trade activities is an important feature of the Government's overall program. Hungary has achieved substantial progress in a short time. Foreign trade organizations, known as IMPEXs, no longer maintain exclusive rights to import and export products. Foreign trade may be undertaken by any economic organization or individual registered with the Government. Three years ago, the Government implemented a program to liberalize the import licensing regime. As of January 1991, 93 percent of imported products no longer require prior approval. Those that still require import licenses are primarily consumer goods which are subject to quotas. The value of the global consumer goods quota was not raised in 1993--it remains at 750 million.

Privatization in Hungary - Tourism

The unfolding of the privatization process is gradually transforming the tourist trade in Hungary. In the hotel industry the three big hotel enterprises have been transformed into share companies. Around 80% of the hotel capacity is now in private hands. However, of the 750,000 places in accommodation, only 60,000 are in hotels. The number of places in private boarding houses and camping grounds increased one and a half times.

Decentralization and Market Economy

In tourism, the switch over to market economy principles have been manifested in the slow but continuous development of the private sector on the one hand, and in the privatization of large state-owned tourist companies (hotel chains, travel agencies, etc.) on the other. In both cases, especially in the latter, foreign capital has played an increasing role.

In the past years the number of travel companies has grown extremely rapidly, and very small private firms, whose services are aimed at the organization of conducted tours by bus to nearby West European countries, have mushroomed. Specialization on certain services is taking place among these companies at present. The privatization of state-owned companies had its greatest triumph in the early 1990s with the partial transfer of IBUSZ, the largest Hungarian travel agency into private ownership. This coincided with the re-opening of the Budapest Stock Exchange after an interval of 42 years. Simultaneously, IBUSZ shares are listed on the Vienna Stock Exchange. The situation of catering services has been similar to that of travel companies.

Among the foreign investors, Austrian firms were the first to enter the Hungarian market. Their appearance was supported by a credit agreement between the Austrian and Hungarian government, which was aimed at the construction of high category accommodation places (four- and five-star hotels). In the field of travel agencies, again, Austrian and to a lesser extent, German firms were the first to benefit from the newly opening opportunities to establish joint ventures with Hungarian companies setting up subsidiaries in Hungary. Geographical proximity, historical tradition, common Central European values and attitudes have rendered these countries especially recipient to doing business in Hungary.

Nevertheless, in certain fields, such as fast-food-restaurants, US and British firms together with their respective Hungarian partners, dominate the market. An example of this is McDonald's success story in Hungary. In 1988, McDonald's Co.

established a joint venture with the huge innovative state farm of Babolna.
The first McDonald's fast food restaurant in Eastern-Europe was opened in Budapest in that year. In the following year, this restaurant produced the highest turnover among the 11,500 McDonald's restaurants all over the world. Since 1988 three other McDonald's restaurants have been established in Hungary. Two are in Budapest, and the third in Gyor, a huge industrial town in Western Hungary. These restaurant are really profitable, and, according to the agreement of the partners, the profit is plowed back into the business. Thus, the Babolna-McDonald's forecasts 4-5 new restaurants in the next few years in Hungary.

CONCLUSION

In Hungary an increasing proportion of production output is coming from the private sector. The 66,000 small private firms and 180,000 one-man firms account for 40 percent of output in 1993. With private firms increasing output at 20-25 percent per year, the state-owned proportion of the economy shrinks fast. The restructuring of state firms has been jointly carried out by the government, foreign investors, banks and other financial intermediaries and Hungarian managers themselves.

However, Hungary faces a large and rising budget deficit. In 1992 the deficit was 7 percent of GDP and in 1993 it had risen to 11 percent. The main cause of the deficit is not increased spending but a fall in government revenues. The fall in national output has meant company profits were lower than they would have been. Since taxes on companies are the main source of revenue, income is falling faster than spending. Hungary's budget deficit was supposed to be 70 billion forints ($9 billion) in 1992. It turned out to be 190 billion. Of the 120 billion shortfall, 100 billion was accounted for by unexpectedly low taxes on company and banking profits. The functional part of the Hungarian economy--the private sector--does not pay taxes, thus to cope with the crisis, further overhauling of the tax system with emphasis on the tax-collecting system is necessary.

On the debt side, the extent of social spending is a problem. Nearly three-quarters of public spending goes on unemployment, health, education and pensions. This is high by international standards, but cannot be easily reduced. The effect of government financing of social spending through debt is a crowding out of borrowing from the private sector. Private sector borrowing is needed for expansion of business to fuel national economic growth. With the Socialist Party coming to power the social safety net is thought to be sacred but a wholesale redesign is necessary for future long-term growth.

It is likely that foreign tourist demand in Hungary will shift to higher quality and more expensive tourism services in the upcoming years. While becoming a financial and commercial center of Eastern Europe, Budapest is likely to attract even more business people. An increase in high quality hotels can only support this trend.

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