

# TRANSITION IN HUNGARY – SOME STRUCTURAL ASPECTS

(CHANGES IN THE BUSINESS SECTOR AND THE CENTRAL GOVERNMENT ACTIVITY)

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## Abstract

There are many aspects of analysing the transition process in Hungary. The paper deals with two characteristic features: the changing structure of the business sector and the decreasing involvement of the government in the Hungarian economy.

*Keywords:* transition, privatisation, business sector, size and forms of businesses, investment, government deficit, indebtedness.

Almost a decade has gone since the beginning of the transformation of the political system in Hungary and a bit more since the launch of an evolution process towards a modern market economy. Changes of such scale had not occurred in the history of the Hungarian economy since the introduction of command economy after World War II.

Making many efforts and sacrifices, observing impressive macroeconomic changes, probably it is time to ask a few questions like:

- did the transition help the modernisation, for example: are the privatized and the newly established enterprises able to compete successfully in the local, regional and the world market? Are they capable of surviving, developing, expanding in the long run?
- how stable, competitive, self-sufficient is the new market economy?
- are the changes irreversible, is there any chance of turning back to the previous period in certain fields (like the role of the government in the economy)?

To answer to these questions we cannot only rely on the general macroeconomical indicators. We have to try to show the inside movements, and focus on some mainly qualitative characteristics, such as the ability and willingness to save, invest, grow, survive, the improvement of competitiveness of products, enterprises, sectors, etc.

We will focus on only two consequences of transition: the capitalisation of the country and the changing role of the government in the economy – connected with the trend of government indebtedness and government deficit.

Trying to analyse the results or failures of the transition period we have to decide how to express the results, what can be used as a standard or measure. Theoretically there are many possibilities, like

- compare the situation with the previous one
- compare the figures to the requirements of the European Union
- compare the Hungarian achievements with those of other Central European countries

None of these methods seems to be perfectly adequate. During the last decade changes were so quick and comprehensive, that it is easy to detect radical changes in almost every field, but it is hard to determine whether those changes were sufficient and synchronized. With respect to the requirements of the EU, even some of the members are not able to fulfill all of them. The other Central European countries did not follow the same pattern during their transition procedure, alas in some fields they lag behind or are ahead of Hungary, or they can choose entirely different methods, speed and targets to prefer. Consequently we will use mixed methods in our evaluation.

## 1. The Results of Privatization – Changing Size and Structure of the Business Sector

### *1.1. Changes in the Number and Size of Businesses*

The Hungarian economy and society became capitalized within a short time due to the quick and in some respects effective privatization process. Quantitative results are impressive.

In 1989 the contribution of the private sector to GDP was 16 percent, in 1993 45 percent [1]. In 1997 more than 70 percent of the GDP was produced by the private sector, 50 percent was produced by the enterprises being in domestic ownership, and 20 percent was produced by enterprises in foreign ownership [2]. The proportion of state property is not bigger than that of the European Union average.

At the beginning of 1997 70 percent of the employees worked in the businesses sector, meaning partly or totally privatized firms [3].

At the beginning of 1997 1 115 809 enterprises were registered in Hungary [3]. The number of businesses has grown quickly, it is now relatively high, compared to Western Europe. The average number of enterprises per

thousand person in the EU countries is 45, while the corresponding number in Hungary is 70 in 1997 [3].

The *structure* of the business sector - considering the size of enterprises - is not proportionate. There are many small, specially so called micro businesses (businesses having less than 10 persons employed are called micro enterprises). There are few medium size firms in Hungary. The lack of medium size businesses could be a problem - specially in the long run - while generally these businesses could be the pivots of development. These businesses are flexible, in most cases are able to invest, absorb easily new methods and can afford to have professional management.

While the number of small businesses has increased quickly during the privatization process, their productivity and the average capital supply lessened. The small firms, specially the micro size ones are not able to invest, many of them started already to use up the invested capital. The venture capital practically does not exist, the rate of interest of bank loans was and is still high, there are only a few incubator houses, and industrial parks, and those businesses represent high risk.

The rate and the number of bankruptcies in this small category were the highest between 1992 and 1996. For example in 1995 out of the 3175 bankruptcies 2235 were represented by small and micro businesses, that is 70.5 percent [4]. That was the period during which many big and medium size former government owned enterprises had to be shut down as well.

The most important reasons for bankruptcies in the small business sector are: high tax burdens, keen competition, the existence of the black economy, everchanging rules and regulations, lack of entrepreneurial and management skills, high interest rates, limited information about the market, narrowing domestic market. Besides these general problems there are some special - hopefully transitory - causes for stagnation and regression of small businesses: many small firms serve only self-employment, these are forced enterprises, the purpose of these is only avoiding unemployment.

People who lost their jobs, used the severance pay or redundancy payment as capital to start with, without any ideas about business plans. Some of the new owners were close to the pension age, they were not able to re-educate themselves and started the business mostly in retail trade. In the age of mushrooming shopping centers and malls their future is not bright. They were the first victims of competition.

Some of the businesses exist only due to tax considerations, or income supplement without real business activity. There is big difference between registered and active firms in Hungary (see *Table 1*).

Many businesses do not want to grow and develop, they change the forms of enterprises according to the changing regulations.

With regard to the form of businesses the number of corporations is still limited, although their number has grown lately.

The *structure* of the business sector according to the number of employees is presented in *Table 1*. There can be observed the difference be-

Table 1. Number of registered and active business organizations and unincorporated enterprises [3]

Staff categories	Registered corporations and unincorporated enterprises		Active corporations and unincorporated enterprises	
	1997		1997	
	January	March	January	March
With more than 300 persons employed	1.249	1.197	1.247	1.196
51-300 persons employed	5.579	5.545	5.335	5.508
21-50 persons employed	9.467	9.570	7.370	7.470
11-20 persons employed	17.046	17.849	9.820	10.231
Less than 11 persons employed	1.081.968	1.028.352	766.658	731.026
Total	1.115.309	1.062.513	790.430	755.431

Source: Central Statistical Bureau. Monthly Bulletin of Statistics. 1997/3. p.38.

tween registered and active firms as well. Enterprises considered operating which have submitted their tax returns in the base period or in the course of the previous year, have been founded in the base period. Enterprises are considered registered but non-operating which have been terminated but which have been in the records due to administrative reasons out of non-compliance with the reporting obligation, have been under liquidation procedure for years, have not been pursuing economic activities, have not yet started, have been founded not primarily for enterprise purposes, have been in operation only occasionally.

The structure of Hungarian enterprises - according to their size - is similar to the EU average at first sight.

In the EU countries the proportion of micro enterprises is 92.4 percent, the proportion of small enterprises is 6.4 and the proportion of medium size enterprises is 1 percent. The corresponding Hungarian figures are at the end of 1996: 96.4, 2.6, and 0.7 percent [2].

There are some differences between the structure of the EU region and Hungary if we take into consideration that, for example according to the official definition in Hungary, a small enterprise has 11-50 employees and

the yearly net sales turnover is maximum 500 million HUF, while in the EU region the corresponding sales figure is 5 million ECU.

The number of registered enterprises has grown sixfold between 1990 and 1996 in Hungary.

The greatest number was established between 1990 and 1992. The rate of increase has stopped from the middle of 1995, and from the beginning of 1996 the number of micro organisations decreased.

In our opinion there are still more business organisations in Hungary than would be necessary taking into consideration the size of the domestic and foreign market. Although the structure of enterprises according to their size in Hungary is similar to the structure of the EU, the average capital supply, the yearly turnover is much smaller in every group in Hungary - consequently the ability to invest and develop.

No doubt, that during the privatization period a significant private sector has developed in Hungary. The legal infrastructure of the market economy has evolved, a network of enterprises has emerged. With regards to the form of businesses, the number of corporations is still limited, although their number has grown lately. The next question is how stable the new business sector generally and in parts is.

This question is closely connected with the *competitiveness* of the products, services, organizations and industries of the sector in the domestic and in the world market.

### *1.2. Changes in Factors Connected with Competitiveness*

There are many ways to express and measure the competitiveness of products and enterprises.

Without striving for perfection we can approach it in many ways, like: the relative price, quality, market position and share, the conditions of sale of products, the research and development activity of firms, their goodwill and financial position, the share of new and qualified products, activities, organization (for example the conformity to the ISO 14001, the ISO 9000 standards, having ECO labels, etc.), ability to absorb capital and new technologies, ability and willingness to expand, to develop in case of firms. We have to take into consideration the expectations of business units as well, their motivations, flexibility, the efficiency of management.

Of course we cannot deal with all the possible components of the competitiveness of the Hungarian business sector, we will concentrate on some aspects only, like the changes in the scale of enterprises (the most important results were already interpreted), and the investment activity of firms.

We can observe that the investment activity of the business sector has started to increase lately after a long period of stagnation and recession.

Table 2. Savings and capital accumulation ratios (at current prices, as percentage of GDP) [6]

	1993	1994	Estimated actual	
	fact	fact	1995	1996
Gross savings	10.6	14.4	20.5	23.2
- households*	8.2	9.9	10.6	12.7
- general government	-0.2	-3.2	-2.5	-1.0
- corporate sector	2.6	7.7	12.4	11.5
Capital accumulation (investment and accumulation of inventories)	20.0	22.2	24.0	25.0
- households	5.1	4.6	4.9	5.0
- general government	4.7	5.0	3.2	2.8
- corporate sector	10.2	12.6	15.9	17.2

\* Household savings include savings of small businesses.

The increased investment activity of the business sector is due to increased savings, the changes in economic policy of the government and many other facts, like the increased activity of foreign investors.

Lately the income redistributing role and the deficit of the general government reduced, consequently the current account improved.

The role of the business sector in the economy increased. The value added by the sector increased, its share in GDP grew as the role of the state in the economy declined. In spite of the overall improvement of the business sector, the strong *differentiation* among companies continued. Those producing for export markets developed dynamically, while those aiming at the domestic market were waiting for the improvement of domestic demand. The fall in domestic demand continued in 1996, but it was counterbalanced by growing exports.

In 1997 there was a slight recovery of domestic demand, the decline of the real income of households stopped. Expectations for the domestic market were positive, and companies anticipate on an acceleration of economic growth.

The prospects of demand in the world economy are uncertain, not mentioning the events in the Far East. Lately the demand of EU and the OECD countries expanded at a declining rate.

The further development of investments made by the business sector depends on the rate of economic growth, the expectations of the domestic and foreign business sector, the role of the Hungarian government, the financing possibilities and on many other events.

Observing the actual trends, we can state that the increment in household savings offset the expansion in the borrowing requirements of the enterprise sector. Besides there is a substantial cutback in the investment expenditure of general government and together with the growth in corporate inventory, the weight of the enterprise sector increased within the accumulation expenditure of the national economy. For example in 1996 companies were representing nearly 70 percent share in total capital accumulation expenditure - meaning that the business sector was going to gain strength.

We can observe some *structural changes in financing activity of enterprises* as well.

The ability of self-financing of medium and bigger size enterprises has grown. For smaller businesses the possibilities and ability of external financing are still limited. As for the international external financing due to the general liberalization and the new foreign exchange law, firms became exclusive agents of drawing in funds from abroad. The amount of net funds raised by enterprises from abroad (foreign direct investments, direct borrowing from non-resident banks, intercompany loans, portfolio investment) approached the deficit in the current account. Previously, this had been shared between general government, the banking and the enterprise sector.

The tendency of companies preferring external funds to Hungarian sources shows the increased confidence of foreign investors and the optimistic profit and market expectations of firms having established relations with international money and capital markets.

Both financial and real processes observed in the business sector during the last year indicate a start of recovery in the economy. The question is how lasting this process will be.

We can expect during the coming year that the selection of enterprises will continue. The temporary improvement of the performance of small businesses was due to their increase in number in the last years. In 1997 the number of small (specially micro) enterprises has dropped, so did their achievements.

Probably the number of enterprises will decrease further for the following reasons: more firms will go bankrupt than will be established, the officially required minimal capital for starting a business grows, the capital necessary for holding on in the competition is bigger than the average capital supply of Hungarian firms, so the number of take-overs, mergers and acquisitions will increase.

The latest figures confirm the forecast. In the first half of 1997 the number of active enterprises has decreased. The biggest reduction was observed amongst the micro organizations.

The reasons for reduction were the increased tax and social security burdens, the slack domestic demand and the lack of competitiveness. The slight increase of medium size enterprises can be a good sign meaning that the sector is able to invest and expand. The number of corporations has

increased as well, indicating the growing importance of firms well provided with capital and the increasing significance of foreign capital (foreign investors prefer corporation form).

There were some further rearrangements inside the business sector: 21 percent of the self-employed micro enterprises became micro enterprises with employees, 5 percent of the micro businesses became small enterprise, and only 1 percent of the small enterprises became medium size business [3]. We have to remember looking at these figures that in Hungary the number of employed people is bigger as a matter of fact, because there is a significant black labor market as well, and quite a big number of the employees are also entrepreneurs.

The role of foreign capital in the investment activity is big, the proportion of foreign investment was 75 percent in 1996, in the first half of 1997 it was about 60 percent [3]. The proportion of foreign proprietorship has grown threefold in the business sector between 1990 and 1997. About 17 billion USD was invested in Hungary in the form of direct investment during the transition period until now, which is the biggest sum in Eastern Europe and exceeds the Russian figure as well.

The rate of growth of foreign investment might be decrease according to some forecasts, due to the relatively small Hungarian market and the increased interests of foreign investors in the expansion to the East. Hungarian joint ventures and some of the stabilized and developing local firms are able to participate in this procedure.

One of the new developments of the activity of successful Hungarian enterprises is the capital export. Private persons are interested in investing abroad as well in the form of buying securities and real estates.

The legal background is provided, the regulation is fairly relaxed now. The value of the total registered direct Hungarian investment abroad was 467.7 million USD in February 1997. 329 million went to the business sector, the rest is to the government and national bank sector. The value of portfolio investments was 38,4 million USD. The contribution of direct investments: two third cash, the rest is contribution in kind. In 1966 there were 472 new registered investments, and the number is 199 in the first quarter of 1997. The investment activity has continued so far. The average value of investments has grown significantly lately. Many real estate was bought in the USA and Spain. The data is probably underestimated because not all types of capital outflow must be declared and investments in securities abroad are not reported at all [7].

All over the world the volume of direct foreign investments has grown more rapidly than the GDP or foreign trade. During the nineties the capital outflow from the OECD countries was three times bigger than during the previous decade.

A new characteristic feature of the international capital flow is that nowadays it is not the privilege of multinational companies, medium size local firms are getting involved in the procedure with or without the multi-



nationals.

The only way of being internationally competitive is to take part in the international capital movements. For smaller enterprises it is a challenge and constraint to become international.

In Hungary the participants are firms that survived the recession, successfully adapted themselves to the new requirements and/or cooperate with the multinationals.

The target countries of capital export were: Austria, Cyprus, Germany, Slovakia, Great Britain, Holland, Poland, Russia and Ukraine. Hungarian investors are very active in Romania (21 joint ventures), and in Ukraine (45 joint ventures) [8].

The most important motivations of expansion were: to find new markets, cheaper labor, productive capacities and in some cases raw materials.

We could observe some new motivations of capital export lately, namely to take part in the accelerated privatization procedure in Estonia, Moldavia, Croatia, and in the states of the former Soviet Union. This is a field well known by the Hungarian investors, some of the old connections are still existing, or can be warmed up easily. Therefore the multinationals offer partnership to the Hungarian firms, with the help of their expertise and familiarity the risk can be reduced. For the Hungarian firms it would be a mistake to miss the unique opportunity. The problem is that the Hungarian firms are short in capital specially venture capital.

If the Hungarian firms do not want to be one sidedly dependent on multinationals they have to expand and be multinationals themselves. This is a severe requirement, because the newly privatized or established firms are busy with tying up themselves and making the necessary reconstruction, paying back the loans, they are certainly not ready for expansion yet. But they have to grow for the survival. By the way they cannot miss the investment opportunities provided by the neighbouring countries. The economical cooperation of the region will very likely be settled before the political situation will calm down.

## 2. Changes in the Participation of the General Government in the Hungarian Economy

The weight of the government in the Hungarian economy has slowly decreased during the transition. After a temporary increase during 1991 and 1995 the government internal and external deficit has started to decline (the peak was in 1994).

Previously the relative importance of the government budget in the Hungarian economy was the biggest one in Eastern and Central Europe. Revenues in 1994 were 53.1 percent of GDP, the expenditures share was 59.5 percent. The corresponding figures in Central and Eastern Europe in

average were 44 percent and 49 percent, in the OECD countries the averages were 37.5 percent and 43.1 percent [9].

The changing role of the government is connected by many ways with the transition.

By using the proceeds of privatization for debt amortization, the level of the country's gross debt moved towards to the convergence with EU criteria. The reform procedures of public finances continued during 1996 and resulted in systematic changes which may render hopefully the new fiscal course sustainable in the long run.

The capital market operations of the central bank over the past years were substantially influenced by the fact that, as a result of the successful privatization effort, international reserves reached USD 10–12 billion.

Increasingly positive results in stabilizing the economy, and growing confidence of the participants of the international money and capital market improved Hungary's international financing rating.

This was manifested in the improving conditions of credits offered and in fall in the secondary market interest premium on Hungarian bonds.

The IMF and the OECD agreed that Hungary was put in the investment category of BBB minus. According to the Standard & Poor's the net foreign debt in 1995 represented 79 percent of the export, in 1997 only 49 percent and in 1998 presumably will not be more than 40 percent. According to the most important credit rationing companies the qualification of Hungary in 1997 is Baa3 (Moody's) and BBB minus (Standard & Poor). Every important credit rating institute (including the Japanese ones) put Hungary in the 'recommended for investors' category.

The conditions of external financing improved. In the near future Hungary does not plan to borrow considerable amounts in the international money and capital markets, hopefully the direct and portfolio investments will continue to flow in.

There is a significant reduction in the general government deficit, both in nominal and real terms, and comparing to GDP. While in 1992 it was 6.9 percent of the GDP, in 1996 it decreased to 3.1 percent of the GDP [6]. The expenditure of general government has decreased as well. The primary expenditure of general government was in 1994 52.9 percent of GDP and 40.5 percent in 1996 [2]. The main reason is that the expenditure of general government decreased (redundancy payments, consumer price subsidies, social expenditures, housing subsidies, enterprise subsidies, etc.), while the revenues declined only slightly.

Even if deficit is calculated without the privatization revenues, and based on the cash flow approach, the situation is improving.

The confidence of foreign and domestic actors of the economy enhanced, inflationary expectations declined, long-term capital inflow surpassed the current account deficit. In 1995 and 1996 foreign direct investment not only financed but remarkably exceeded the deficit in the current account. Taking into consideration that the USD 1.7 billion current account

deficit in 1996 could be financed with the almost 2 billion foreign direct investment, there was no need to raise additional funds.

The outstanding amount of privatisation revenue added to the reserves, that reached USD 12 billion in 1996 [2] enabled prepayments reducing gross debt. In 1995-96 the amount of prepayments were USD 2.6 billion, consequently Hungary's gross foreign debt calculated net of intercompany loans declined from its 1994 peak value by USD 4.5 billion to USD 26.3 billion. The net external debt which includes intercompany loans went down from USD 18.3 billion to USD 12.9 billion in 1996.

As a result of the massive capital inflows, the transformation of the debt structure continued: the proportion of the public sector in net foreign debt exclusive of intercompany loans declined from 69 percent in 1995 to 61.4 percent in 1996 [3].

The debt indicators of the country have improved. Taking into consideration the financial macroeconomic criteria of Maastricht, Hungary in two fields almost fulfills the requirements, namely the proportion of the government deficit to GDP, which cannot exceed 3 percent, and the proportion of gross government debt, which cannot exceed 60 percent of GDP (in both cases a slight excess is accepted in case of declining tendency).

Hungary's government deficit represented the 6.5 percent of GDP in 1995, and 3.3 percent of GDP in 1996. In 1994 the deficit was equal to the 8.5 percent of GDP [10].

*Table 3. The gross government debt as a percentage of GDP in Hungary (1990-1996) [10]*

	1990	1991	1992	1993	1994	1995	1996
Consolidated gross government debt	60.3	67.6	65.4	83.7	83.7	86.1	75.1

There are significant lags in the Hungarian economy considering the other respects of the Maastricht criteria, like: the required rate of inflation, the average interest rate of long-term loans, and the stability of the exchange rates. There is no hope that these criteria will be satisfied in the near future.

Regarding the mentioned two criteria that seems to be successfully completed, we have to study whether is it any danger of keeping the recent position, and what are the possible further developments.

Concerning the government deficit, the privatization is almost finished, no more revenue can be expected. If the present rate of growth will not be temporary, hopefully less transfer payment and government support will be needed. The repayment and interest obligations of government securities might relatively decrease due to the more favourable money and capital market conditions.

The riskiest factor is the structure of government budget and the possible obligations taken by the future government. The social and political pressure is strong, the comprehensive budget reform is still not completed. The tax rates are high but the discipline of payments is lax. The significance of the black economy is considerable (it produces about 20–25 percent of the GDP), and probably will stay around at the same level in the near future.

The general government indebtedness hopefully can be managed in the foreseeable future. The conditions of internal financing can be improving, if the propensity to save and invest of the households and the business sector will grow. These depend on the rate of growth.

Although the increase in the volume of the world trade slowed down with respect to both goods and services lately, if the international competitiveness of Hungarian firms will improve, the performance of the economy's foreign trade might improve. There are certain promising signs in this field. For example the structure of exports and imports changed favourably in the last year.

There are still many risks and uncertainties in the Hungarian economy, but in our opinion the changes went so far, the market mechanism is strong enough the sufficient parts of the businesses are already self-supporting and able to develop, meaning, that there is no real chance of any reversal.

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