Private Sector Development During Transition
The Visegrad Countries

Michael S. Borish
Michel Noël
Recent World Bank Discussion Papers

No. 251  Supply and Demand for Finance of Small Enterprises in Ghana. Ernest Aryeetey, Amoah Baah-Nuako, Tamara Duggleby, Hemamala Hettige, and William F. Steel

No. 252  Projecting the Governance Approach to Civil Service Reform: An Environment Assessment for Preparing a Sectoral Adjustment Loan in the Gambia. Rogerio F. Pinto with assistance from Angelous J. Mrope

No. 253  Small Firms Informally Financed: Studies from Bangladesh. Edited by Reazul Islam, J. D. Von Pischke, and J. M. de Waard

No. 254  Indicators for Monitoring Poverty Reduction. Soniya Carvalho and Howard White

No. 255  Violence Against Women: The Hidden Health Burden. Lori L. Heise with Jacqueline Pitanguy and Adrienne Germain

No. 256  Women's Health and Nutrition: Making a Difference. Anne Tinker, Patricia Daly, Cynthia Green, Helen Saxenian, Rama Lakshmanarayanan, and Kirrin Gill

No. 257  Improving the Quality of Primary Education in Latin America and the Caribbean: Toward the 21st Century. Lawrence Wolff, Ernesto Schiefelbein, and Jorge Valenzuela

No. 258  How Fast is Fertility Declining in Botswana and Zimbabwe? Duncan Thomas and Ityai Muvandi

No. 259  Policies Affecting Fertility and Contraceptive Use: An Assessment of Twelve Sub-Saharan Countries. Susan Scribner


No. 261  Poverty Alleviation and Social Investment Funds: The Latin American Experience. Philip J. Glaseyner, Kye Woo Lee, Anna Maria Sant'Anna, and Jean-Jacques de St. Antoine

No. 262  Public Policy for the Promotion of Family Farms in Italy: The Experience of the Fund for the Formation of Peasant Property. Eric B. Shearer and Giuseppe Barbero


No. 264  Schooling and Cognitive Achievements of Children in Morocco: Can the Government Improve Outcomes? Shahidur R. Khandker, Vidyasagar, and Deon Filier

No. 265  World Bank-Financed Projects with Community Participation: Procurement and Disbursement Issues. Gita Gopal and Alexandre Marc

No. 266  Seed Systems in Sub-Saharan Africa: Issues and Options. V. Venkatesan

No. 267  Trade Policy Reform in Developing Countries Since 1985: Review of the Evidence. Judith M. Dean, Seema Desai, and James Riedel

No. 268  Farm Restructuring and Land Tenure in Reforming Socialist Economies: Comparative Analysis of Eastern and Central Europe. Euroconsult and Centre for World Food Studies

No. 269  The Evolution of the World Bank's Railway Lending. Alice Galenson and Louis S. Thompson

No. 270  Land Reform and Farm Restructuring in Ukraine. Zvi Lerman, Karen Brooks, and Csaba Csaki

No. 271  Small Enterprises Adjusting to Liberalization in Five African Countries. Ron Parker, Randall Riopelle, and William F. Steel

No. 272  Adolescent Health: Reassessing the Passage to Adulthood. Judith Senderowitz


No. 274  Social Action Programs and Social Funds: Review of Design and Implementation in Sub-Saharan Africa. Alexandre Marc, Carol Graham, Mark Schacter, and Mary Schmidt

No. 275  Investing in Young Children. Mary Eiming-Young

No. 276  Managing Primary Health Care: Implications of the Health Transition. Richard Heaver

No. 277  Energy Demand in Five Major Asian Developing Countries: Structure and Prospects. Masayasu Ishiguro and Takamas Akiyama

No. 278  Prewishment Inspection Services. Patrick Low

No. 279  Restructuring Banks and Enterprises: Recent Lessons from Transition Countries. Michael S. Borish, Millard F. Long, and Michel Noel

No. 280  Agriculture, Poverty, and Policy Reform in Sub-Saharan Africa. Kevin M. Cleaver and Graeme Donovan

No. 281  The Diffusion of Information Technology: Experience of Industrial Countries and Lessons for Developing Countries. Nagy Hanna, Ken Guy, and Erik Arnold

(Continued on the inside back cover)
World Bank Discussion Papers

Private Sector Development During Transition

The Visegrad Countries

Michael S. Borish
Michel Noël

The World Bank
Washington, D.C.
Discussion Papers present results of country analysis or research that are circulated to encourage discussion and comment within the development community. To present these results with the least possible delay, the typescript of this paper has not been prepared in accordance with the procedures appropriate to formal printed texts, and the World Bank accepts no responsibility for errors. Some sources cited in this paper may be informal documents that are not readily available.

The findings, interpretations, and conclusions expressed in this paper are entirely those of the author(s) and should not be attributed in any manner to the World Bank, to its affiliated organizations, or to members of its Board of Executive Directors or the countries they represent. The World Bank does not guarantee the accuracy of the data included in this publication and accepts no responsibility whatsoever for any consequence of their use. The boundaries, colors, denominations, and other information shown on any map in this volume do not imply on the part of the World Bank Group any judgment on the legal status of any territory or the endorsement or acceptance of such boundaries.

The material in this publication is copyrighted. Requests for permission to reproduce portions of it should be sent to the Office of the Publisher at the address shown in the copyright notice above. The World Bank encourages dissemination of its work and will normally give permission promptly and, when the reproduction is for noncommercial purposes, without asking a fee. Permission to copy portions for classroom use is granted through the Copyright Clearance Center, Inc., Suite 910, 222 Rosewood Drive, Danvers, Massachusetts 01923, U.S.A.

The complete backlist of publications from the World Bank is shown in the annual Index of Publications, which contains an alphabetical title list (with full ordering information) and indexes of subjects, authors, and countries and regions. The latest edition is available free of charge from the Distribution Unit, Office of the Publisher, The World Bank, 1818 H Street, N.W., Washington, D.C. 20433, U.S.A., or from Publications, The World Bank, 66, avenue d'lena, 75116 Paris, France.

ISSN: 0253-210X

Michael S. Borish is a financial analyst in, and Michel Noël is chief of, the Country Operations Division, Country Department II, of the World Bank's Europe and Central Asia Regional Office.

Library of Congress Cataloging-in-Publication Data

Borish, Michael S., 1956-
Private sector development during transition: the Visegrad countries / Michael S. Borish, Michel Noël.
p. cm.—(World Bank discussion papers; 318)
Includes bibliographical references (p. ).
HD4140.7.B67 1996
338.943—dc20 96-10 CIP
CONTENTS

FOREWORD ............................................................ vii

ABSTRACT ............................................................. viii

ACKNOWLEDGEMENTS ................................................... ix

ACRONYMS ............................................................ x

I. OVERVIEW .......................................................... 1

II. COMPARATIVE ASSESSMENT OF THE ENABLING ENVIRONMENT .......... 2
  A. Introduction ..................................................... 2
  B. Legal Framework for Enterprises in the Visegrad Countries .......... 3
     1. Introduction ................................................. 3
     2. Civil Codes and Property Rights ................................ 3
     3. Business Registration Practices, and Corporate Structure and
        Governance ...................................................... 6
     4. Commercial Codes and Contract Enforcement ...................... 14
     5. Bankruptcy and Liquidation ................................... 18
  C. Regulation and Competition in the Visegrad Countries .............. 23
     1. Introduction ................................................. 23
     2. Customs Regulations and Trade ................................ 23
     3. Labor Markets .................................................. 28
     4. Investment and the Financial Sector ............................. 31
     5. "Natural" Monopolies ........................................... 41
  D. Taxation .......................................................... 55
  E. Foreign Investment ............................................... 59

III. COMPARATIVE ASSESSMENT OF PRIVATIZATION ............................ 64
  A. Introduction ..................................................... 64
  B. Methods of Enterprise Privatization Used by the Visegrad Countries ..... 64
     1. Summary of Privatization Methods and Objectives ............... 64
     2. Country Reviews of Privatization Laws and Methodologies ........ 65
  C. General Results of Enterprise Privatization in the Visegrad Countries .... 71
     1. Summary ....................................................... 71
     2. Country Reviews of Enterprise Privatization ..................... 73
     3. The Remaining State Sector ................................... 81

IV. COMPARATIVE ASSESSMENT OF PRIVATE SECTOR DEVELOPMENT ............ 87
  A. Introduction ..................................................... 87
  B. Enterprises: Private Sector Trends By Sector and Country .......... 88
     1. Summary ....................................................... 88
     2. Czech Republic ............................................... 88
     3. Hungary .......................................................... 93
     4. Poland .......................................................... 100
     5. Slovak Republic ............................................... 110
V. CONCLUSION ................................................................. 119
A. Strengthening the Enabling Environment for Private Sector Development 119
   1. Strengthening Property Rights .................................. 119
   2. Easing Business Registration .................................. 119
   3. Improving Contract Enforcement .............................. 120
   4. Improving Bankruptcy and Liquidation Procedures ....... 120
   5. Improving the Workings of Labor Markets ............... 121
   6. Enhancing Financial Sector Capacity ...................... 121
   7. Easing the Tax and Social Insurance Burden ............. 122
B. Accelerating Privatization ........................................ 123
C. Increasing Investment in the Private Sector .................. 123
   1. Domestic Financial Institutions ............................ 123
   2. Foreign Direct Investment .................................. 124

ANNEXES
1. LEGAL, REGULATORY AND INSTITUTIONAL DESCRIPTIONS .... 125
2. POLITICAL/ECONOMIC CHRONOLOGY: CZECH AND SLOVAK REPUBLICS 130
3. POLITICAL AND ECONOMIC CHRONOLOGY: HUNGARY .......... 137
4. POLITICAL AND ECONOMIC CHRONOLOGY: POLAND .......... 147

BIBLIOGRAPHY .............................................................. 157

BOXES
1. Overview of Visegrad Countries’ Legal, Regulatory and Institutional Environment .... 2
2. Business Registration and Capital Requirements in the Visegrad Countries ........ 7
3. Corporate Structure and Governance in the Visegrad Countries .................. 8
4. Demonopolization and Privatization in Infrastructure and Utilities .......... 43
5. Tax Rates in Visegrad and EU Countries ........................................ 56
6. Summary of Privatization Features in the Visegrad Countries .................. 64
7. Summary of Non-Microenterprise Privatization Results in Visegrad Countries ... 72
8. Privatization in the Czech Republic .................................... 74
9. Privatization in Hungary ........................................... 76
10. Privatization in Poland ............................................. 77
11. Poland’s Mass Privatization Program .................................. 79
12. Privatization in the Slovak Republic .................................. 81
13. The Remaining SOE Sector in the Visegrad Countries .................. 82
14. The State Sector in Hungary ........................................ 84
15. The State Sector in Poland .......................................... 85
16. The State Sector in the Slovak Republic ............................ 86
17. A Tale of Two Sectors .............................................. 103

TABLES
1. Comparative Visegrad and European Union Incomes and GDP: 1993 ............... 1
2. EU Association Agreement Timetable for the Visegrad Countries ............. 25
4. Sector Shares of GDP in the Visegrad Countries .................................. 87
TABLES (cont’d)
5. Private Sector Growth in the Visegard Countries .................................. 87
6. Private Sector Shares/Trends in the Czech Republic .............................. 88
7. Lending Patterns in the Czech Republic ............................................. 91
8. Deposit Patterns in the Czech Republic ............................................. 92
9. Private Sector Shares/Trends in Hungary .......................................... 94
10. Growth in the Number of Private Hungarian Firms .......................... 94
11. Firm Size, Value Added and Employment Trends in Hungary ............... 96
12. Lending, Borrowing and Investment Trends in Hungary .................... 97
13. Private Sector Deposits in Hungary ................................................. 98
15. Private Sector Shares/Trends in Poland .......................................... 100
16. An Overview of the Polish Private Sector Contribution in GDP ............ 102
17. Private Sector Employment in Poland .............................................. 104
18. Lending Trends in Poland ............................................................ 105
20. Deposit Mobilization, Investment and Disintermediation in Poland ....... 108
21. Investment Trends in Poland .......................................................... 108
22. Private Sector Shares/Trends in the Slovak Republic ......................... 111
24. Number and Share of Registered Private and State Companies in the Slovak Republic ....................................................... 113
28. Deposit Structure by Economic Sector ............................................. 116
Private sector development and privatization have been prime components of Bank lending programs in transition countries from the beginning of reform efforts to devolve market-oriented economies. This has clearly been the case in the Visegrad countries, all four of which rank among the most industrialized and economically developed of the many countries which have embarked on the path of structural adjustment and transformation in recent years. While the Visegrad countries have all followed differing approaches to achieve sustainable economic growth, private sector development has been an essential component in all countries from the start.

To promote private sector development, states and donors have encouraged increasing liberalization of the legal and regulatory framework, accelerated privatization, and a general broadening and deepening of financial markets to stimulate enterprise privatization to meet the growing financial needs of the emerging private sector. Clear progress has been achieved in all three areas, although considerable work remains if the Visegrad countries are to be globally competitive in the coming years. On the one hand, the private sector continues to increase its contribution to output and employment, a favorable trend expected to continue. On the other hand, serious weaknesses remain in terms of institutional capacity to implement legal and regulatory reforms, complex privatizations of large industrial companies, and banking and capital markets. The ability to move from macroeconomic stabilization to resolution of outstanding structural weaknesses will determine the ability of the individual Visegrad countries to move forward to rising levels of competitiveness and prosperity.

This paper focuses on the legal and regulatory framework, taking a close look at (i) business registration practices, corporate governance, contract enforcement, and property rights; (ii) competitive practices regarding trade, labor markets, investment, and natural monopolies; and (iii) taxation and foreign investment. Having set the context, the authors then proceed to review privatization and private sector development from the beginning of the economic transition, reviewing (i) privatization transactions, values and methodologies; (ii) remaining state sector assets, and timetables for divestiture; and (iii) overall private sector development trends regarding output, employment, firm size, credit, deposit mobilization, trade and investment.

As most transition countries have only recently begun to pursue major restructuring and privatization campaigns in a meaningful way, the paper is primarily descriptive of trends and developments mid-way between the onset of transition and full implementation of European Union Association Agreements. This paper is part of a broader effort by our department to analyze financial and enterprise sector reform issues, with the intention of identifying desirable design features for current and future program interventions in transition countries.

Kemal Derviş
Director
Europe and Central Asia Department
Country Department II (EC2)
ABSTRACT

As the immediate aftershocks of the transition to market economies wane (opening to the West, collapse of CMEA, recession in Europe), the Visegrad countries face the key challenge of achieving sustainable economic growth. The economies of the Visegrad countries are showing an increasing percentage of output, employment, investment and trade from the private sector, which will contribute to sustainable growth. On the other hand, the industrial sectors of these countries have significant state ownership, with loss-making enterprises responsible for significant fiscal and quasi-fiscal losses that undermine competitive advantages. Structural weaknesses, perpetuated by government resistance to needed privatizations and, in some cases, to foreign direct investment, undermine competitiveness and development of a viable fiscal base.

After five years of transition, privatization of the state sector and private sector development remain incomplete. Despite indisputable progress, particularly from the nascent private sector, Visegrad countries still lag global standards of output, investment and efficiency. Legal and regulatory frameworks are still inadequate, largely due to the lack of trained personnel and institutional capacity to implement. Privatization remains incomplete, with thousands of industrial companies partly or wholly owned by governments. Private sector development is constrained by firm-specific weaknesses concerning modern management practices, and larger problems associated with banking, capital markets, and general financial sector infrastructure. For Visegrad countries to achieve globally competitive standards, these obstacles will have to be overcome.

The objective of this paper is to analyze the conditions needed to achieve sustainable private sector growth in the Visegrad countries. The analysis focuses on (i) the "enabling" environment (legal and regulatory framework, institutional capacity); (ii) privatization of state enterprises; and (iii) private sector development (new companies, privatized companies).
ACKNOWLEDGEMENTS

The authors would like to thank the many Bank staff who assisted in producing this Discussion Paper. Special thanks go to Luca Barbone (ECA) and Andrew Ewing (PSD) for their helpful comments. The authors wish to thank the many Task Managers and Research Assistants for their contributions. Special attention goes to Burcak Inel and Marguerite Nguyen for research and data collection. The authors would also like to thank Laila Tushan, Sahra Harbi and Joumana Freund for their help with processing.
<table>
<thead>
<tr>
<th>ACRONYMS</th>
</tr>
</thead>
<tbody>
<tr>
<td>APVRt</td>
</tr>
<tr>
<td>AVRt</td>
</tr>
<tr>
<td>AVU</td>
</tr>
<tr>
<td>BOE</td>
</tr>
<tr>
<td>BOT</td>
</tr>
<tr>
<td>BSE</td>
</tr>
<tr>
<td>CEFTA</td>
</tr>
<tr>
<td>CIS</td>
</tr>
<tr>
<td>CPI</td>
</tr>
<tr>
<td>CSFR</td>
</tr>
<tr>
<td>EBRD</td>
</tr>
<tr>
<td>ECU</td>
</tr>
<tr>
<td>EFTA</td>
</tr>
<tr>
<td>EU</td>
</tr>
<tr>
<td>FDI</td>
</tr>
<tr>
<td>GATT</td>
</tr>
<tr>
<td>GDP</td>
</tr>
<tr>
<td>GoC</td>
</tr>
<tr>
<td>GoH</td>
</tr>
<tr>
<td>GoP</td>
</tr>
<tr>
<td>GoS</td>
</tr>
<tr>
<td>GSP</td>
</tr>
<tr>
<td>HUF</td>
</tr>
<tr>
<td>IPF</td>
</tr>
<tr>
<td>ITA</td>
</tr>
<tr>
<td>K</td>
</tr>
<tr>
<td>NASD</td>
</tr>
<tr>
<td>NIF</td>
</tr>
<tr>
<td>NPF</td>
</tr>
<tr>
<td>OECD</td>
</tr>
<tr>
<td>OTC</td>
</tr>
<tr>
<td>OZ</td>
</tr>
<tr>
<td>PSE</td>
</tr>
<tr>
<td>SEC</td>
</tr>
<tr>
<td>SK</td>
</tr>
<tr>
<td>SME</td>
</tr>
<tr>
<td>SOCB</td>
</tr>
<tr>
<td>SOE</td>
</tr>
<tr>
<td>VAT</td>
</tr>
<tr>
<td>WSE</td>
</tr>
<tr>
<td>WTO</td>
</tr>
</tbody>
</table>
I. OVERVIEW

The objective of *Private Sector Development During Transition: The Visegrad Countries* is to review progress in private sector development and analyze conditions required for Visegrad countries—the Czech and Slovak Republics, Hungary and Poland—to achieve sustainable private sector growth. The private sectors in the Visegrad countries currently generate about half of GDP and employment, compared to little more than 10-20 percent in 1990. Thus, the private sector shows favorable growth trends in all Visegrad countries, much of it from new private enterprises that have been established in recent years. This bodes well for Visegrad country competitiveness and their prospects for integration into the European Union early next century. Nevertheless, the share of the private sector in GDP is still much smaller in the Visegrad countries today than in the European Union (EU), high-growth and middle income countries, where the private sector frequently accounts for most GDP and employment. Major challenges remain in terms of increased productivity and competitiveness as a result of (i) the still large state sectors in Hungary, Poland and Slovak Republic; and (ii) the need for continued restructuring in the recently privatized sectors of all Visegrad countries.

Section II reviews the enabling environment for private sector development (legal and regulatory framework, institutional capacity) in Visegrad countries, pointing out areas where progress has occurred as well as where the enabling environment needs improvement. Section III reviews the privatization of state enterprises, and remaining state shares of the economy. Section IV assesses private sector development (new and privatized companies) in the Visegrad countries in the 1990s. Section V then summarizes recommendations for the four Visegrad countries to improve enabling environments, accelerate the privatization of state enterprises, and increase the flow of investment into the private sector from both domestic and external sources. Table 1 provides a brief profile of Visegrad countries’ 1993 output and income figures compared to the European Union.

| Table 1: Comparative Visegrad and European Union Incomes and GDP: 1993 (in US$) |
|-----------------|-----------------|-----------------|-----------------|-----------------|
| Visegrad Countries | European Union |                 |                 |                 |
|                  | Czech | Hung | Poland | Slovak | Avg | Low | Mid | High |
| 1993 PPP Per Capita Income | 7,700 | 6,260 | 5,010 | 6,450 | 17,082 | 11,728 | 17,984 | 21,534 |
| 1993 GDP Per Capita | 2,730 | 3,400 | 2,270 | 1,900 | 19,753 | 12,096 | 20,868 | 26,294 |
| 1993 GDP (US$ mil) | 28,182 | 34,952 | 87,272 | 10,156 | 485,398 | 165,912 | 584,762 | 705,521 |

EU Low includes Greece, Portugal, Ireland, Spain, Finland; EU Middle includes Sweden, UK, the Netherlands, Italy, Belgium; EU High includes Austria, Denmark, France, Germany, Luxembourg; EU Low, Middle and High represent averages for the five countries included.

II. COMPARATIVE ASSESSMENT OF THE ENABLING ENVIRONMENT

A. Introduction

For countries to encourage sustainable levels of private sector growth, they must have an accommodating and enforceable legal, regulatory and institutional framework in place which conforms to international standards and stimulates production, trade and investment. The Visegrad countries have improved their enabling environments considerably in recent years. This is one of the major contributing factors to the steady growth of private sector GDP since 1992 and private sector employment since 1990. Nevertheless, significant weaknesses remain which will need to be corrected for successful integration into the EU market and global competitiveness. This section focuses on the enabling environment for enterprises in each of the four Visegrad countries, with particular attention paid to (i) legal frameworks; (ii) regulations; (iii) taxation; and (iv) foreign investment.

<table>
<thead>
<tr>
<th>Business Registration</th>
<th>Civil Code</th>
<th>Bankruptcy Liquidation</th>
<th>Taxation</th>
<th>Foreign Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Czech Republic:</strong></td>
<td>Need: simultaneous processing, fewer locations; improvement since 1990</td>
<td>Conflict of interest; limited bankruptcy, liquidation; tax rules limit debt write-offs</td>
<td>Focus on liquidation, not corporate restructuring; weak dispute resolution, court capacity</td>
<td>High tax rates lead to avoidance; only country without holidays</td>
</tr>
<tr>
<td><strong>Hungary:</strong></td>
<td>Registration easy; large informal sector due to high taxes, not registration procedures</td>
<td>Extensive use of bankruptcy + liquidation; small-scale transactions follow Civil Code</td>
<td>Strong capacity; recent amendments should increase effectiveness</td>
<td>Open trade &amp; investment; demonstration of infrastructure and utilities</td>
</tr>
<tr>
<td><strong>Poland:</strong></td>
<td>Taxes + fee requirements provide perverse incentives to keep firms under-capitalized</td>
<td>Collateral legislation needs central registry for liens, more creditor recourse, market-based liquidation</td>
<td>Restrictive tenancy, multiple titles, costly land registration, lack of bank recourse lowers credit</td>
<td>Out-of-court regime; common; collateral protection, judicial infrastructure limit court use</td>
</tr>
<tr>
<td><strong>Slovak Republic:</strong></td>
<td>Needed: simpler, unclear Code, weak court, lower fees, more capacity, lack of creditor recourse all lead to poor contract enforcement</td>
<td>Restrictive tenancy, weak title and bank recourse undermine property rights; need new Collateral Law</td>
<td>Limited capacity; Open trade; obstacles to investment, privatization, demonopoliz'na</td>
<td>High rates; holidays, guarantees, exemptions, other incentives not successful</td>
</tr>
</tbody>
</table>

Box 1: Overview of Visegrad Countries' Legal, Regulatory and Institutional Environment
B. Legal Framework for Enterprises in the Visegrad Countries

1. Introduction

The legal framework found in market economies is composed of a complex array of laws that provide guidelines for property rights, the entry and governance of firms, contract enforcement, and methods of exit from the market. Models vary based on degrees of property protection, ease of entry and merger/acquisition for new firms, shareholder rights and concentration, contract enforcement and dispute resolution measures, the duration of bankruptcy and liquidation procedures, and a host of related tax, investment, labor and other issues. Nevertheless, while models may vary, most market-based economies have enshrined protection of private property in their laws and provided levels of transparency and recourse in their implementation to function in a competitive environment. This represents a point of departure from the legal framework that existed in countries pursuing policies of central planning. At the outset of transformation, the Visegrad countries had laws and regulations that reflected the period of central planning, with virtually no protection of private property nor recourse to legal institutions to reverse unfavorable treatment. Since 1988-1990 when the transition began, the Visegrad countries have improved their body of laws and regulations to be more conducive to private sector development. However, to achieve more competitive standards, many observers believe they will need to address to various extents several key weaknesses in the coming years: (i) restrictive Collateral Laws, inadequate property registries, and unclear title to property which undermine the use of collateral for secured transactions; (ii) slow or cumbersome registration procedures, disincentives to companies to start-up and register with higher levels of founding capital, and problems associated with corporate governance; (iii) weak or unclear Commercial Codes, insufficient judicial infrastructure, and underdeveloped market mechanisms for contract enforcement; and (iv) ineffective or limited use of bankruptcy and liquidation procedures¹ to enhance market discipline and contract enforcement.

2. Civil Codes and Property Rights

The Visegrad countries have made progress in recent years equalizing the status of private property with that of public property, and improving the protection of property rights. However, Civil Code weaknesses in Visegrad countries remain. These include (i) restrictive tenancy laws; (ii) weak and incomplete property registries for land and movable properties; and (iii) limited use of mortgages for secured lending because of weaknesses in legal infrastructure (see "B4. Commercial Codes and Contract Enforcement"). The Visegrad countries are showing heightened respect for owners' property rights, updating and centralizing property registries, strengthening court capacity, and encouraging development of financial market infrastructure for repossession and resale. Nevertheless, private investors and financial institutions are often insufficiently protected in practice, resulting in (i) lower investment levels in commercial, residential and agricultural properties; and (ii) less use of secured transactions in the absence of clear perfection of collateral. The consensus points to the direction that Visegrad countries should (i) clarify and update Civil Codes to ensure property protection; (ii) accelerate the centralization and automation of property registries to avoid multiple pledges/liens on the same property; (iii) reverse constraints to investment, such as restrictive tenancy laws and weak Collateral Laws; (iv) strengthen in-court and out-of-court capacity to resolve property disputes; and (v) provide clear guidelines for creditor recourse to properties pledged by debtors in default, including immovable assets (real estate). Such reforms would contribute significantly to efforts to better enforce contracts (see "B4. Commercial Codes and Contract Enforcement"), a prerequisite for investor confidence and economic growth.

¹ Hungary is an exception in that effectiveness has been undercut by excess reliance on court-oriented bankruptcy and liquidation procedures, rather than better use of transparent and de-politicized out-of-court procedures.
Czech Republic

Ownership and property rights in the Czech Republic are defined in the 1964 Civil Code, with significant amendments added in 1992 legitimizing private property and equalizing the legal status of public and private property (effectively abolishing socialist property guidelines). As the majority of real estate in the pre-reform period was state-owned, the establishment of property rights required not only legal reform, but also the extension of private holdings of property through restitution, privatization and rentals. Progress has been made in this direction. However, problems remain regarding tenancy, property registration and use, and the use of mortgages as collateral for financing. The Czech real estate market is distorted due to restrictive tenancy practices such as (i) rent controls, which keep rents low at the expense of maintenance and investment; (ii) tight restrictions on eviction, which limit mobility, maintenance and investment; and (iii) the requirement that alternative housing must be found first before a tenant leaves the premises. Consequently, there is a significant shortage of space/premises which, combined with high prices, makes it difficult for new businesses to find affordable new space. This can serve as a constraint to business development and expansion, including to a dynamic residential and commercial real estate sector. This will not occur until clear title is established for property. To achieve this, the Czech Republic needs to update, modernize and centralize its land registry and property system. Many transfers to/among state entities (particularly before 1964) have not been recorded, therefore records are not always reliable. This undermines creditors' claims to real estate pledges, reducing incentives for the use of mortgages as collateral for financing. Mortgages were rarely used after 1949, and mortgages and pledge were omitted from the 1964 Civil Code. Dramatic changes occurred with the transition to a market economy, privatization, restitution, and the rental of state-owned space. However, mortgage lending will also require market-based banking, suitable protection of collateral rights for secured transactions, and a change in foreclosure procedures. Strengthening collateral concepts in the Civil and Commercial Codes would encourage these developments.

Hungary

The 1963 Civil Code in Hungary (amended in 1990) was designed for small, non-commercial private transactions, and is widely used as a legal basis for contract enforcement (see "B4. Commercial Codes and Contract Enforcement"). It also serves as a basis for recognition of property rights, including private property, and can be used for real estate to serve as collateral for loans. Nevertheless, as found elsewhere in the Visegrad countries, problems remain concerning tenancy, property registration and mortgage financing which constrain private sector growth. The main problem with regard to tenancy is restrictive eviction procedures, which require landlords to find alternative housing for those they want to evict. Non-payment of rent has not been acted on as cause for eviction or mortgage foreclosure. Difficulties in evicting tenants have led to less investment and real estate development than would otherwise occur with more balanced incentives. Land and property registries are not up to date or accurate (on ownership) in urban or rural areas. While most housing is private (and useful as collateral), land registration generally takes six months, slowing real estate transactions. Agricultural land records are in poor condition because of past nationalization and the regrouping of cooperatives. Problems related to authority over zoning and building regulations persist in urban areas. Property disputes in rural areas continue to impede privatization in the agricultural sector. Some bankruptcy and liquidation cases have been slowed by disparate property registries, which have traditionally been housed on a decentralized basis in Hungary's 19 regions/provinces. GoH is currently drafting revisions to the Civil Code which will establish a unified framework for the registration of mortgages and movable assets. This

---

2 Prague commercial office rental rates were about 50 percent higher than in Vienna at end 1994. See Business Central Europe, June 1995.
represents progress, as there is currently no way to register liens on movable property. Once adequate property registries are established, foreclosure costs should decline and processing should accelerate. Meanwhile, mortgages and mortgage lending are undercut by a series of factors. Arrears on wages, severance pay and tax claims are superior to registered mortgage liens, subordinating the position of mortgage lenders and reducing their incentive to provide mortgage-backed loans. Even if the credit hierarchy were reorganized to provide mortgage lenders with a more favorable position, difficulties of repossession would likely limit the call on housing collateral. This likewise serves as a deterrent to the provision of mortgage-backed loans. Also, while Hungary is generally an open market for foreign investors, direct foreign financing of commercial property is not possible because foreign banks cannot register mortgage liens on Hungarian real estate.

Poland

1989 amendments to Poland’s 1964 Civil Code abolished socialist property classifications, and allowed SOEs to own fixed assets. By 1990, the distinction between private and personal property was abolished. Changes in 1990 generally established the legal framework for local government taxation and revenue rights, spending responsibilities, land use planning, housing management, and infrastructure provision. All government levels were granted the right to sell land.

While the legal framework became more open and decentralized, a number of enforcement issues remain problematic. State-owned rent/tenancy is strictly controlled, which slows commercial development and housing finance because of weak eviction and foreclosure powers. There are also no clear rules on the sale/transfer of cooperative property, which slows multi-family dwelling construction. Property registration is time-consuming, expensive, and laden with risks to creditors because (i) liens on movable assets are generally not possessory (although some exceptions are made for banks), constraining the seizure and sale of assets when contract terms are not fulfilled; (ii) when liens on movable assets are possessory (via "executory title", whereby banks can seize collateral without first going to court), the most recent lien has priority over earlier liens issued for the same property; and (iii) there is no unified register yet for liens on movables (currently, there are 19 registries), which makes it easier for debtors to pledge the same assets to multiple creditors. This makes lenders reluctant to engage even in secured lending to avoid dual/multiple claims on assets when disputes arise. In terms of processing, notarization requirements can slow transactions. While municipalities can issue bonds for development, majority foreign corporations need permission from the Ministry of Interior to buy land or enter into long-term leases. This slows infrastructure and commercial real estate development, two areas where Poland is weak and lacks sufficient public resources for development. The process of transferring state property to local governments and SOEs, and the restitution of property to private owners has left ownership of land unresolved in many cases, adding to the inaccuracy of property registers. Furthermore, while buildings may be private, the status of land is less clear. This raises the risk of investment in properties and premises, resulting in fewer assets available for secured transactions. Consequently, this reduces the use of mortgages for mortgage-based lending. Some progress is underway in drafting a new Collateral Law which will clarify the use of mortgages and movable properties in secured transactions. This will provide the legal context for establishment of a unified register for liens on movable properties. Simultaneously, Poland is in the process of strengthening its property registries by (i) establishing a

---


4 Warsaw’s prime office rental rates were 2.5 times Vienna’s rates at end 1994, and higher than those in Paris, London and Berlin. See Business Central Europe, June 1995.
central registry for all liens;\(^5\) (ii) equipping the central registry with automated information systems on liens for mortgages and movable assets; and (iii) providing judicial training to ensure the modernization of Poland's registries are used by courts for contract enforcement and dispute resolution. However, until these reforms are in place, property rights in Poland will suffer from a lack of clarity, and this could hamper private investment and growth.

Slovak Republic

As with the Slovak Commercial Code, the Civil Code is sufficiently unclear in many cases to lead to poor enforcement of property rights. As in the other Visegrad countries, rent and tenancy are distorted by excess protection of tenants, rent controls, and title uncertainty. Title uncertainty affects the ownership of shops and residences, and serves as a disincentive to investment and maintenance.\(^6\) Despite these characteristics, real estate prices are high due to scarcity.\(^7\) Only with increased investment will supply increase and prices become more affordable. Such constraints to business premises are a major constraint to business development, and point to how crucial the issue of ownership is in private sector development. The Land Law recognizes ownership (including land transferred with privatization), but property registration and ownership are complicated by local government ownership of commercial property, housing, and agricultural and vacant land. Continued government ownership of properties has stifled housing construction, the growth of shops in offices and apartment complexes, and agricultural production. Lagging privatization of land has also slowed the development of mortgage lending and the use of land or premises for collateralized loans. While the conversion from short-term to long-term leases could help, many experts believe privatization would be a much more direct method to alleviate constraints to secured transactions. However, even with land privatization and secured lending, other changes would be required to provide collateral protection for secured lenders. A lender's right to the use of movable goods (equipment, inventories) for collateral is not adequately protected, therefore the limited use of collateral for lending is compounded by the lack of supportive institutional arrangements (registration, conflict adjudication) required for enforcement in a market economy.


Business registration practices have improved in recent years in the Visegrad countries, although full registration takes more than one month for most companies except in Poland.\(^8\) At the outset of the transformation process, registration was costly and cumbersome in all four Visegrad countries due to (i) the shortage of trained notaries; (ii) multiple visits required for administrative approvals; and (iii) time required for approvals. Since then (beginning in the early 1990's), business registration has been made easier, as indicated by the significant increase in the number of registered enterprises (see Section IV). Nevertheless, about two-thirds of newly registered companies in the Czech Republic, Hungary and the Slovak Republic needed up to six months to register, indicating business registration practices remain cumbersome in those countries. Only in Poland do registration practices appear not to be cumbersome.

---

\(^5\) Lien registration will still be carried out by the 49 local registry courts currently responsible for commercial registration. However, information requests on liens will be answered. This, along with heightened security for claims, will allow lenders to perfect security for repayment.

\(^6\) Shops typically operate on month-to-month leases absent title to land. Therefore, occupants have little incentive to properly maintain premises for investment appreciation and resale.

\(^7\) Prime office rental rates at end 1994 exceeded those in Vienna by about 25 percent. See Business Central Europe, June 1995.

\(^8\) See "Venture Capital & Entrepreneurship in Central & East Europe", EU-Phare, August 1994.
or time-consuming. Box 2 highlights business registration and capital requirements in the Visegrad countries.

With regard to corporate structure, (i) most larger firms are joint-stock companies with multiple shareholders, limited liability, and boards that monitor management performance; (ii) medium-scale firms are often limited liability companies, with lower levels of required capital, fewer shareholders, and less formal supervision than joint-stock companies; and (iii) partnerships exist with limited and unlimited liability. Six years into the transition, corporate governance in large- and medium-sized Visegrad enterprises is still often problematic due to (i) dispersed ownership; (ii) limited availability of skilled board members; (iii) weak information disclosure from management to board members; and (iv) poor use of available information by management. As in other middle income countries (and in higher income countries as well), smaller enterprises often suffer from weak governance because owner-managers tend to be responsible for all aspects of the business, even those areas where the owner-manager clearly lacks skills. Box 3 highlights different structures and governance requirements in the Visegrad countries. (A more descriptive summary is found in Annex 1).

<table>
<thead>
<tr>
<th>Box 2: Business Registration and Capital Requirements in the Visegrad Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business Registration:</strong></td>
</tr>
<tr>
<td>* Czech Republic: Requires notarized founding contracts and statutes, applications with Commercial Registry for each business activity, permits from local government.</td>
</tr>
<tr>
<td>* Hungary: Firms required to have notarized articles of association. Registration costs for small enterprises are 2% of initial capital.</td>
</tr>
<tr>
<td>* Poland: Small firms must have notarized articles of association, pay stamp duties (2% of investments with capital under OZ 50 million, or US$ 2,000, plus 1% for incremental capital), and proceed to the Court of Registration.</td>
</tr>
<tr>
<td>* Slovak Republic: Requires multiple filings for taxes, customs, social security, environmental assessments, and health and safety inspections. Trade licenses require information on educational qualifications and criminal records.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Joint Stock Companies:</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>* Czech Republic: Minimum capital: K 1 million (about US$ 35,000). Paid-in capital must be 30% of subscribed total and in cash. Capital reserve of 10% plus annual 5% retention from net earnings until it reaches 20% of capital stock.</td>
</tr>
<tr>
<td>* Hungary: Minimum capital: HUF 10 million (about US$ 70,000), of which 30% must be paid in at registration.</td>
</tr>
<tr>
<td>* Poland: Minimum capital: OZ 1 billion (US$ 40,000).</td>
</tr>
<tr>
<td>* Slovak Republic: Minimum capital: SK 1 million (US$ 30,000).</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Limited Liability Companies:</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>* Czech Republic: Minimum capital: K 100,000 (about US$ 3,500).</td>
</tr>
<tr>
<td>* Hungary: Minimum capital: HUF 1 million (about US$ 7,000).</td>
</tr>
<tr>
<td>* Poland: Minimum capital: OZ 40 million (US$ 1,600).</td>
</tr>
<tr>
<td>* Slovak Republic: Minimum capital: SK 100,000 (about US$ 3,000).</td>
</tr>
</tbody>
</table>

Sources: C. Gray, "Evolving Legal Frameworks for Private Sector Development in Central and Eastern Europe"; internal World Bank reports; "International Business Practices", University of Missouri-St. Louis; "Investment in Poland", KPMG.
Box 3: Corporate Structure and Governance in the Visegrad Countries

**General Summary:** There are three general sets of companies in the Visegrad countries apart from owner-operated firms: (i) joint-stock companies; (ii) limited liability companies; and (iii) partnerships. Joint-stock companies are comparatively large, with broad ownership, more extensive reporting requirements, minimum capital requirements ranging from US$ 30,000 in the Slovak Republic to US$ 70,000 in Hungary. This is comparable to EU ranges of about US$17,000 in Greece to as high as US$127,000 in Italy, with Belgium, the Netherlands, Sweden, Germany, Spain and Denmark ranging from US$44,000-92,000. Joint-stock companies generally have a Board of Directors and a Supervisory Board. The Board of Directors is elected at the general (annual) meeting. Supervisory Boards in firms with greater than 50-200 employees usually elect one third of their members by employees, and two-thirds by shareholders. Limited liability companies are often small- or medium-scale enterprises (SMEs) with minimum capital of US$ 1,600 in Poland to US$ 7,000 in Hungary. In EU countries, the average is US$20,000, with Spain the lowest (about US$4,000) and Denmark and Germany the highest (about US$36,000). Limited liability companies are usually managed by at least one "statutory representative" appointed by the general meeting. All countries have partnerships with (i) unlimited (joint and several) liability, which evenly distributes obligations and benefits; and (ii) "unlimited liability" for managing partners plus "limited liability" for others based on capital contribution. Partnerships are generally governed on the basis of capital contribution and potential liability concerns.

<table>
<thead>
<tr>
<th>Country</th>
<th>Joint Stock</th>
<th>Limited Liability</th>
<th>Partnerships</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech</td>
<td>Minimum capital: K 1 million (about US$ 35,000).</td>
<td>Minimum capital: K 100,000 (US$ 3,500).</td>
<td>The Visegrad countries generally have two types of partnerships: (i) limited, where the managing partner has unlimited liability, but partners have limited liability up to the amount of their investment; and (ii) unlimited partnerships, with unlimited, joint and several liability for all partners.</td>
</tr>
<tr>
<td>Hungary</td>
<td>Minimum capital: HUF 10 million (US$ 70,000).</td>
<td>Minimum capital: HUF 1 million (US$ 7,000). Must be managed by at least one director.</td>
<td>Sources: C. Gray, &quot;Evolving Legal Frameworks for Private Sector Development in Central and Eastern Europe&quot;; internal World Bank reports; Oxford Analytica; &quot;International Business Practices&quot;, University of Missouri-St. Louis; &quot;Investment in Poland&quot;, KPMG; EU embassies.</td>
</tr>
<tr>
<td>Poland</td>
<td>Minimum capital: OZ 1 billion (US$ 40,000). Articles of incorporation can restrict the voting power of large shareholders to prevent excess concentration of shareholder decision-making power.</td>
<td>Minimum capital: OZ 40 million (US$ 1,600). Shareholders free to determine dividends, voting rights, management and board members.</td>
<td></td>
</tr>
<tr>
<td>Slovak</td>
<td>Minimum capital: SK 1 million (US$ 30,000). Board of Directors elected at the general (annual) meeting. Supervisory Boards in larger firms must elect 1/3 of their members by employees, and 2/3 by shareholders.</td>
<td>Minimum capital: SK 100,000 (US$ 3,000).</td>
<td></td>
</tr>
</tbody>
</table>

9 Technically, Belgium, Denmark, Greece and Spain do not have joint-stock companies. However, their public limited liability companies have some of the same features (higher minimum capital requirements).

10 From high to low: (i) Denmark (US$ 36,900); (ii) Germany (US$ 35,791); (iii) Belgium (US$ 26,224); (iv) the Netherlands (US$ 25,641); (v) Greece (US$ 12,970); (vi) Italy (US$ 12,689); (vii) Sweden (US$ 7,000-14,000); and (viii) Spain (US$ 4,197).
Czech Republic

The Czech Republic has an open trade and investment regime which has encouraged significant growth in services and stimulated high levels of foreign investment. Special licenses and permits are required for investments in defense, postal services and salt production. Otherwise, the Czech Republic has an open investment regime. The Czech Republic also makes virtually no distinction between domestic and foreign investors, neither providing special preferences nor applying protection.

As in the other Visegrad countries, investment in the Czech Republic involves a series of business registration and establishment requirements that are generally uniform for domestic and foreign investors. Most large firms register as joint-stock or limited liability firms, with minimum investment requirements of K 1 million (US$ 35,000) and K 100,000 (US$ 3,500), respectively. Among the Visegrad countries, these requirements are comparatively low for joint-stock companies and in the middle range for limited liability firms. Both kinds of firms are required to establish and maintain a reserve fund in "readily realizable" assets as part of founding and ongoing capital.

Setting up a company in the Czech Republic remains complicated and costly for about half of new businesses. In most cases, registration takes one to three months to process, and half the companies experience significant problems to register. Registration requirements for Czech businesses include preparing a founding contract and statutes in the form of a notarial deed, and applying for registration with the Commercial Registry. The Law on the Pursuit of Trade Activities (adopted in 1992) requires most companies to obtain a business license before they can register with the Commercial Registry, which alone often requires three months. This process includes a separate application for each business activity, which compounds paperwork requirements. Businesses must also obtain a permit from the local council to open a business office, which involves showing it has a lease, and demonstrating the property is zoned for commercial use. If business registration involves residential property, the owner must apply for a "change of use" permit. These requirements must be satisfied in succession, which is time-consuming because of delays and sequencing.

In addition to some registration and licensing bottlenecks, many Czech businesses encounter problems associated with corporate governance. This largely relates to (i) dispersed ownership structures; (ii) limited recourse to bankruptcy for corporate reorganization; and (iii) bank ownership of Investment Privatization Funds (IPFs). Dispersed ownership of Czech enterprises results from the Czech Republic's mass privatization program (see Section III), which has consisted largely of voucher privatization. Individuals who received vouchers usually placed their investments with IPFs, which invested in privatized companies. However, IPFs are limited to 20 percent ownership of companies, and they usually own far less. Limitations on enterprise ownership by IPFs disperse IPF representation on boards, weaken IPF ability to represent shareholder interests, and reinforce the position of management, all of which undermine corporate governance at the enterprise level. Such disincentives to IPFs to exercise greater supervisory control over companies in which they invest have prompted many IPFs to become portfolio managers focused on aggregate returns, rather than strategic investors focused on company-specific returns, adding to the cycle of inadequate corporate governance at the enterprise level. Meanwhile, bankruptcy focuses on the liquidation of an enterprise rather than as a tool for corporate reorganization. This effectively erases shareholder value before needed financial and operational restructuring occurs.

While 48 percent of firms experienced no problems obtaining registration, licensing or permits, 41 percent experienced "moderate" problems and 10 percent experienced "big" problems. Only 29 percent of Czech firms were able to obtain all needed licenses and permits within one month, while (i) 59 percent needed one to three months, (ii) 10 percent needed three to six months, and (iii) 2 percent needed more than six months. See "Venture Capital & Entrepreneurship in Central & East Europe", EU-Phare, August 1994.

Each application costs K 1,000 (US$ 35).
As creditors, banks have an incentive to roll over loans to report these loans as performing, even when companies are technically insolvent. Whereas an IPF may call for needed restructuring to contain losses or restore shareholder value for their portfolios, banks are often more interested in reporting performing loans to minimize write-offs and accounting losses. Bank initiation of bankruptcy proceedings against delinquent debtors would prompt loan write-offs and weaken reported financial results. Thus, banks in their roles as creditors often conflict with the role of IPFs as shareholders, undermining corporate governance. Finally, banks own IPFs. Along with their role as creditors to enterprises, banks are in a position to undermine the role of IPFs in corporate governance to protect their creditor position. As a bank’s credit exposure is usually far in excess of its exposure to enterprises in which their IPFs have invested, the creditor role can consequently take precedence over the bank’s indirect shareholder role.

**Hungary**

Hungary has an open trade and investment environment, reflecting a general commitment to competition in the spirit of its Association Agreement for entry into the European Union. Investment in Hungary involves a series of business registration and establishment requirements, with larger firms generally registering as joint-stock or limited liability firms. Hungary has the highest minimum investment requirements for joint-stock (about US$ 70,000) and limited liability (about US$ 7,000) companies among the Visegrad countries. Special government concessions are required for investment in telecommunications networks and services, transport infrastructure (roads, railways, harbors, airports, trains) and haulage, electric power stations and powerlines, extraction of natural resources, pipelines, radioactive products, pharmaceuticals, gambling, and postal services. Otherwise, domestic and foreign investors are generally free to invest in a competitive economy.

Business registration in Hungary is not considered a barrier to entry for most new (and small) businesses, although processing is time-consuming and about one in 10 firms (usually complex or larger) encounters significant difficulties and delays. Some of this is due to processing requirements at the local government level. Only about one-third of businesses are able to obtain needed licenses and permits within one month, and nearly half of new companies experience "moderate" or "big" problems. For

---

13 With the adoption of new accounting and loan classification regulations, such room for rollovers is diminishing. Over time, this should put pressure on creditors to restructure troubled loans at a minimum, which may eventually impose some needed restructuring on the troubled enterprises themselves.

14 The Law on the Prohibition of Unfair Market Services (1990) established the Competition Agency to ensure competition. The Act on Unfair Market Behavior (1991) reinforced anti-monopoly legislation. While free trade and investment with selective regulation is viewed as preferable to anti-monopoly legislation and Competition Commissions, these laws reflect Hungary's post-socialist legal framework and commitment to stimulating competition on a market basis.

15 In Hungary, 52 percent of firms experienced no problems obtaining registration, licensing or permits. However, 36 percent experienced "moderate" problems, and 12 percent experienced "big" problems. Only 30 percent of firms were able to obtain all needed licenses and permits within one month, while (i) 43 percent needed one to three months, (ii) 18 percent needed three to six months, and (iii) 8 percent needed more than six months. See "Venture Capital & Entrepreneurship in Central & East Europe", EU-Phare, August 1994.
larger firms, the business registration process can take up to nine months due to the involvement of a full judicial process.\textsuperscript{16} 

Corporate governance has been undermined in Hungary by (i) the retention (partial or total ownership) by the state of hundreds of enterprises (the state had equity of about US$ 12 billion in 740 enterprises in mid-1995, or about 25 percent of 1995 GDP); (ii) soft budget constraints on loss-making enterprises; and (iii) the inability of the tripartite system (GoH, management, unions) to achieve or maintain enterprise competitiveness without subsidization. Recent changes in the Law on Privatization adopted in May 1995 are expected to reverse some of these weaknesses. Nevertheless, until there is a tightening of subsidies to enterprises, state banks undergo major restructuring, and a more aggressive approach to privatization is demonstrated, the state will have influenced corporate governance in a manner that has deferred needed restructuring and market discipline. By mid-1995, the state still had at least partial ownership in 740 enterprises (see Section III) and frequently maintained decisive voting positions, often delaying needed enterprise restructuring to protect jobs and production. Enterprise consolidation programs in which the state intervened to alter or reverse restructuring decisions seriously undermined corporate governance and weakened management efforts to make certain SOEs viable. This, in turn, prompted the need for direct and indirect public sector subsidies to the loss-making SOE sector, which took the form of budgetary transfers, Social Security arrears, and foregone debt servicing and repayment. Foregone enterprise debt service to banks prompted multiple bank recapitalizations approximating US$ 3.2 billion from 1991-1994, which added to a costly cycle in which neither enterprises nor banks exercised market discipline. To the contrary, GoH subsidization and recapitalization added an element of moral hazard into the corporate decision-making of both enterprises and banks, deferring needed restructuring and adding to the costly fiscal deficit.\textsuperscript{17} With the state frequently demonstrating its willingness to bail out uncompetitive SOEs and state-owned banks, Hungary's corporatist tripartite approach to corporate governance failed to achieve the needed restructuring required for enterprises to successfully compete in a market economy. Despite these problems, Hungary has significantly attractive assets which it intends to sell in the next few years to generate sales proceeds and help stabilize the economy. With passage of the new Privatization Law and increasing public awareness of the need to bring down public debt and fiscal deficits, Hungary is now poised to reverse these weaknesses in corporate ownership, structure and governance.

Poland

Investment in Poland involves a series of business registration and establishment requirements, with larger firms generally registering as joint-stock or limited liability firms. Minimum investment for joint stock companies is OZ 1 billion (about US$ 40,000).\textsuperscript{18} For limited liability firms, minimum investment is OZ 40 million (US$ 1,600). Neither of these sums is considered prohibitive. These capital

\textsuperscript{16} The details of each company's application need to be reviewed by a judge, who is typically overloaded and inexperienced in commercial affairs. The annual caseload of an average judge in the Budapest registry court is 1,200 registrations and amendments to articles of incorporation. The registration process is further complicated by the requirement that companies must list all the activities they intend to pursue, resulting in reapplications each time the business entity enters a different activity. The 15-day appeal period after initial approval for registration also slows the process, while the inclusion of unlimited partnerships into the required registration process further burdens the courts.


\textsuperscript{18} OZ denotes the old zloty (officially PLZ), with a 1994 average exchange rate of 25,000 to the US dollar. In early 1995, Poland introduced the new zloty (PLN) with a conversion rate of 10,000 old zlotys for one new zloty.
levels are higher than the Czech and Slovak Republics for joint-stock companies, but lower than the other Visegrad countries for limited liability firms. A license or permit is required for investment in undersea natural resource extraction, non-ferrous metals, wholesale trade in tobacco and alcohol, poisonous and toxic substances, weapons, explosives, air transport, international land transport, sound and vision on tapes, records, cassettes, films, mail services, and gambling. For investments of 5-10 percent of the shares of companies listed on the Warsaw Stock Exchange, investors must report such purchases to the Securities Commission, the Anti-Monopoly Office, and to the company itself.

Compared with her Visegrad neighbors, business registration is least cumbersome in Poland. About three-quarters of firms experience no problems with registration, and half of firms receive licenses and permits in one month or less. Business registration requirements for limited liability and joint-stock companies consist of (i) obtaining a permit to set up a company (from the relevant Ministry); (ii) signing company articles and statutes (at the Notary office); (iii) entering the Commercial Registry (at the Registry Court); (iv) obtaining a statistical number (from the local Statistical Office); (v) informing the Ministry of Industry of business formation; (vi) opening a bank account; and (vii) registering for tax purposes with the local tax office. Requirements for partnerships and owner-operated businesses are less demanding, as permits and licenses are not required. However, notary fees and stamp duties are high for small companies, providing them with incentives to invest with less than needed capital. Combined with high tax rates applied to limited liability and joint-stock companies, notary fees and stamp duties encourage firms to incorporate with minimum capital.

Corporate governance in Poland has often been weakened by (i) delays in privatizing SOEs; (ii) dispersed ownership structures, including when privatization has occurred; and (iii) scarcity of qualified personnel to serve on enterprise supervisory boards. Although the recent initiation of "mass privatization" is a positive development, recent political developments may point to GoP efforts to retain influence over a large number of enterprises. Poland, with more than 5,000 SOEs (see Section III), has delayed privatization for several reasons: (i) GoP has long held the position that companies should take the lead in initiating their own restructuring programs; (ii) GoP wanted to avoid any political responsibility for layoffs that could result from restructuring; and (iii) GoP believed it could ultimately sell enterprises at higher prices to domestic investors once the economy turned around. While SOEs have been given the option of voluntarily privatizing, a large number has remained state-owned. In nearly 1,000 cases, state companies have been "commercialized", which has meant (i) converting them to joint-stock company status under the control of the state Treasury; (ii) providing employees with 10 percent of shares at no cost; (iii) providing employees with one-third of the seats on the supervisory board; and (iv) bringing corporate governance requirements to these enterprises in accordance with the Commercial Code. However, corporate governance and enterprise restructuring have been undermined by (i) reluctance in some cases to let redundant workers go; (ii) reluctance in other cases to terminate social services traditionally provided by SOEs (health facilities, food services), particularly in one-company towns where these services are not readily available from alternative sources; and (iii) willingness to

---

19 In Poland, 76 percent of firms experienced no problems obtaining registration, licensing or permits. Only 19 percent experienced "moderate" problems and only five percent experienced "big" problems, both comparatively low for Visegrad countries. Half of firms were able to obtain all needed licenses and permits within one month, while (i) 35 percent needed one to three months, (ii) 10 percent needed three to six months, and (iii) 5 percent needed more than six months. See "Venture Capital & Entrepreneurship in Central & East Europe", EU-Phare, August 1994.

20 Notary fees are usually up to OZ 50 million (US$ 2,000), and stamp fees are 2 percent of equity for investments with less than OZ 50 million (US$ 2,000) plus up to 1 percent for incremental capital.
allow SOEs and commercialized companies to accumulate arrears on Social Security and other liabilities. Corporate governance has also been undermined by the entrenched position of management in many companies, which has resulted from dispersed ownership. Among SOEs and commercialized companies, public sector officials are often not qualified to exercise proper governance in a market-based business. Among the more than 3,000 privatized, commercialized or liquidated companies, hundreds have been privatized through employee buy-outs. In addition to lacking qualifications for adequate corporate governance, in many cases the large number of employees with shares has made exercising governance problematic. The result in the less successful cases has been greater reliance on management without adequate information or accountability provided to supervisory boards and shareholders.

Slovak Republic

Based on the Commercial Code, investment involves several business registration and establishment requirements. Most large firms incorporate as joint-stock companies, with minimum capital requirements of SK 1 million (about US$ 30,000), the lowest among Visegrad countries. Limited liability company capital requirements are a minimum SK 100,000 (about US$ 3,000). Neither is considered prohibitive. As in the Czech Republic, both kinds of firms are required to establish and maintain a reserve fund in "readily realizable" assets as part of founding and ongoing capital. Regarding licenses and permits, some industrial sectors are closed to private entry (defense, postal services, distillation of pure alcohol, railways). In addition, foreign nationals may not acquire real estate in the Slovak Republic, though in practice they do through Slovak subsidiaries.

Business registration is often unnecessarily complex and time-consuming in the Slovak Republic, particularly for large enterprises and foreign investors. More than half of firms experience significant problems with the registration process, by far the poorest performer among Visegrad countries. Licensing and permits generally require one to three months. Registering a business and obtaining needed licenses and permits involve (i) multiple visits; (ii) repeated filings; and (iii) delays for environmental assessments, health and safety inspections, social security and tax payments, customs, and certificates concerning criminal records and education and training. Businesses of all sizes also complain the process is made more cumbersome because of a general lack of information, and inconsistent interpretations of licensing requirements.

While direct public subsidies have been halted, many of the SOEs and commercialized companies have been freed of the burden of past obligations, although coming up with new money has been difficult due to limits on credit and equity investment. Banks have been reluctant to lend, because these companies (i) were also often delinquent on their past loans; and (ii) represent excess risk to bank portfolios at a time when banks are ill-equipped to assess risk, and are able to generate profits more easily by investing in GoP securities. Such indirect subsidization combined with lack of access to formal credit and equity markets has slowed enterprise restructuring.

This statement can be qualified, as some SOEs are showing positive results financially and operationally. Much of this success has to do with improved corporate governance, including better flows of information to/from management and their use for business planning and decision-making. However, in many other cases, SOEs and ex-SOEs are doing poorly for a range of reasons. These reasons often include weaknesses in governance and management.

In the Slovak Republic, only 39 percent of firms experienced no problems obtaining registration, licensing or permits. Fifty-three percent experienced "moderate" problems, and 9 percent experienced "big" problems. Only 29 percent of firms were able to obtain all needed licenses and permits within one month, while (i) 51 percent needed one to three months, (ii) 12 percent needed three to six months, and (iii) 7 percent needed more than six months. See "Venture Capital & Entrepreneurship in Central & East Europe", EU-Phare, August 1994.
As in the Czech Republic, Slovak businesses sometimes encounter problems associated with corporate governance because of dispersed ownership and limited use of bankruptcy. However, more than in the Czech Republic and partly due to the ability of IPFs to play a role in restructuring enterprises, the Slovak Republic has entrenched management based on what are often perceived to be overt political relationships. This has been done through the recently established Employer's Association, Entrepreneur Association, Industry Union, Union of Cooperatives and other organizations that benefitted from their managerial positions during the era of central planning. Recently (July 1995), the Slovak government amended the Law on Large-Scale Privatization which cancelled the scheduled second wave of mass privatization in favor of a bond scheme administered by the state-owned National Property Fund (NPF). The main effect was to eliminate IPFs from playing an intermediary role in favor of the NPF, as bondholders are required to invest these bonds directly into properties or companies held by NPF. The nature of this process has served to (i) maintain ownership within state hands and entrench traditional managers; (ii) weaken information disclosure and possibly management accountability to supervisory boards; and (iii) constrain the ability of IPFs to play a more active role on corporate supervisory boards.

4. Commercial Codes and Contract Enforcement

Contract enforcement is a general problem in the Visegrad countries due to inadequate Commercial Codes, weak court capacity, undeveloped liquidation infrastructure, and limited bank recourse for loan recovery. Limited creditor recourse undermines credit and investment, stifling private sector growth. While all four countries have improved their codes in recent years, institutional weaknesses and protection of defaulting companies have undermined contract enforcement. The general consensus is that the Visegrad countries need to (i) update their Commercial Codes to provide a more suitable legal framework for contract enforcement in a market economy; (ii) strengthen court capacity to adjudicate fairly and swiftly, and developing out-of-court procedures to resolve contract disputes; (iii) promote market-based liquidation companies to facilitate secondary market development for pledged assets; and (iv) create additional recourse for banks to recover and/or write down loans, including development of secondary debt markets. Lack of contract enforcement constrains investment and liquidity, and ultimately slows private sector development and economic growth.

Czech Republic

The Company Law of the Czech Republic was adopted in January 1992, and covers company law and all commercial contracts (including domestic and foreign investment). The new Commercial Code covers goods, credit, licensing, storage, and finance (letters of credit, deposits, security). One weakness is that there is no law preventing senior civil servants from pursuing independent business interests which could lead to potential conflict of interest and problems of corporate governance. However, there have been major improvements since 1990, such as (i) putting private contracts on an equal footing with public contracts; (ii) introducing market-based guidelines concerning "offer and acceptance", fraud, duress, and other contractual issues; and (iii) introducing an amendment to the Civil Code in 1992 (recognizing claims to pledges of movable and immovable properties) which laid the groundwork for Commercial Code recognition of mortgages and pledges, and their use as mechanisms for contract enforcement.


25 An estimated 90 percent of the eligible Slovak population had signed up for participation in the voucher scheme, which has been delayed since 1993.

26 The bonds, which are not guaranteed by the central bank, mature in 2001, one year after the current government's term in office.
In general, contract enforcement can be problematic because of difficulties associated with bankruptcy and liquidation (see "B5. Bankruptcy and Liquidation"). Court capacity is limited for dispute resolution, largely due to lack of training of judges and bailiffs in commercial affairs. This creates delays when disputes go to court, rendering court processes less effective. Out-of-court procedures are also limited, largely due to training of judges and bailiffs in commercial affairs. With insufficiently developed bankruptcy and liquidation procedures, there has been little incentive for market-based liquidation companies to develop, play a role in secondary markets for pledged assets, and accelerate contract enforcement measures. Some private companies have formed to assist with factoring (payables, receivables), although these efforts generally do not involve pledged assets. Factoring companies offset and liquidate current arrears, thereby assisting with contract enforcement. However, because bankruptcy and liquidation processes are still underdeveloped in the Czech Republic, there is limited recourse to enforcing contracts for long-term assets on a timely basis at relatively low cost. To improve contract enforcement, most observers believe the Czech Republic should (i) make bankruptcy and liquidation more efficient and less time-consuming by strengthening in-court and out-of-court mechanisms for dispute resolution; (ii) provide banks with more of an incentive to use bankruptcy as a mechanism for corporate reorganization, rather than exclusively as a tool of liquidation; and (iii) encourage the formation of market-based liquidation companies to enforce bankruptcy, liquidation and restructuring agreements.

Hungary

Commercial transactions in Hungary are increasingly conducted according to sections of the earlier 1963 Civil Code (amended in 1990) designed for small, non-commercial private transactions. The Code (i) incorporates basic principles of offer, acceptance and performance; (ii) provides standard terms for about 25 types of transactions (sales contracts, real estate leases); and (iii) provides a legal doctrine on negative events (bad faith dealing, illegal contracts, deception). However, delays can be problematic because the court system has been overwhelmed with filings. This slows business registration as well as dispute resolution. By taking on more requests than it can handle, the court-oriented system has thereby undermined the practical use of the Commercial Code to enforce contracts.

The Commercial Code has been used extensively since 1992 for contract enforcement when Hungary's courts began to play an active role in the bankruptcy (filed by management) and liquidation (filed by creditors) proceedings of debtor enterprises (see "B5. Bankruptcy and Liquidation"). This has led to extensive development of court infrastructure, albeit insufficient relative to the volume of cases filed since 1992. Recently adopted reforms to improve bankruptcy legislation and harmonize property registries, combined with existing market-based liquidation firms will provide Hungary with enhanced in-court capacity to properly enforce contracts in the coming years. Along with improvements in staffing (qualified bailiffs, judges), compensation and training (exposure of judges to bankruptcy principles and practices), improved legislation and strengthened institutions should provide banks and others with enhanced legal and institutional recourse to recover debts. By contrast, Hungary has so far largely failed to demonstrate adequate out-of-court procedures to resolve disputes. The Debtor Conciliation Scheme, introduced in late 1993 and abolished in mid-1995, was designed to reduce the work load for courts. It did not work because of (i) excess interference from line ministries and state agencies (AVU, AVRt) in negotiations with the banks on behalf of troubled debtor enterprises; and (ii) a mandate for state agencies to purchase loans from banks at book values, providing debtor enterprises with additional time and resources to operate without strict restructuring conditions attached. Rather than relying exclusively on court proceedings, Hungary could very likely benefit from the development of (i) out-of-court institutions

Since the original law until mid-1995, more than 5,000 bankruptcy and 22,000 liquidation cases have been filed. Courts have decided on about 60 percent of bankruptcies and 25 percent of liquidations. However, most of these filings were in the first 18 months of the new law. Consequently, measures were taken to reduce the number of filings, as well as to reduce asset diversion from debtor enterprises to "new" enterprises that were not impacted by court decisions.
to assist with debt resolution (on the condition that out-of-court resolutions are achieved without negotiations being swayed by the intervention of line ministries, AVPRt or other state agencies); and (ii) secondary debt markets, to provide a faster, market-based solution to selected contract disputes.

**Poland**

Weaknesses in Poland's 1934 Commercial Code relate closely to weaknesses (collateral legislation) in the Civil Code. Since 1990, Poland has introduced new legislation and passed several amendments to existing legislation to improve the legal framework. However, many legal analysts and business people believe significant shortcomings remain with regard to the lack of uniformity in the Commercial Code. This is further compounded in many cases by difficulties associated with institutional enforcement of contracts under Poland's Commercial Code. Most problematic is the lack of enforcement resulting from the high cost of bailiffs, their lack of reliability in terms of scheduling, and the refusal of bailiffs to execute evictions.

_**In-court capacity** is weak due to (i) slow and costly procedures; (ii) the cumbersome process of litigating based on 1934 legislation; (iii) personnel weaknesses (insufficiently trained judges, poor staffing levels, low compensation); and (iv) a significant increase in the volume of incoming cases._

In terms of institutional agents, incentives are distorted for several reasons: (i) secured creditors are low on the credit hierarchy (after procedural costs, employee compensation arrears, arrears on taxes and social insurance, rents due on government-owned property, and all arrears on taxes, social security and customs owed to government), reducing the willingness of banks to make even secured loans; (ii) unsecured non-bank creditors are below unsecured bank creditors on the credit hierarchy, negatively impacting trade credit, enterprise liquidity, and overall development of factoring markets; and (iii) procedural costs for the execution of liens are high (at 10 per cent of the loan amount paid up front) and time-consuming, with uncertain prospects. In response to the backlog and obstacles found in the court system, _out-of-court procedures_ have been developed with some success. There is now virtually no backlog in the system, largely because of the use of out-of-court procedures. In particular, Poland has used out-of-court procedures since 1993 in a limited, time-bound process to restructure delinquent enterprise debt as part of the Enterprise and Bank Restructuring Law. By 1995, this process involved more than 200 debt restructurings valued at OZ 7.6 billion (about US$ 300-350 million), and had been a key component of bank and enterprise sector restructuring in Poland. In most cases, these disputes were adjudicated by

---

28 There are 29,600 judicial employees in Poland's court system, of which nearly 7,500 are judges, judge assessors and judge applicants and about 22,000 are support staff.

29 About US$ 50 million was spent from the national budget to operate courts that provide business, land and mortgage registration. This averages to US$ 175,000 per district court, which hears about 10,000 registration-related cases per year. Thus, about US$ 17.50 is allocated per case to cover operating costs, most of which are compensation.

30 In 1990, courts received 90,000 business registration cases and zero concerning land registration. There were an additional 499,000 civil cases which included commercial disputes. Total case load was 2.4 million cases, most family-related. In 1994, the courts received 2.1 million registration cases, of which 2.0 million were land-related. There were an additional 746,000 civil cases. Total case load was 4.9 million cases, of which 43 percent were registration-related. Adding civil cases to the load, about 58 percent of total case load was registration- or civil-related. With only 286 district courts, these courts currently average about 10,000 registration and civil cases per year, compared with little more than 2,000 in 1990.

31 While the Law will remain in effect, provisions for out-of-court conciliation agreements expire in February 1996, three years after passage of the Law.
banks, which were empowered to negotiate work-out agreements on behalf of all creditors (providing a
majority of creditors based on debt value gave their approval). While the magnitude of physical and
operational restructuring at the enterprise level remains open to question,32 such out-of-court debt
restructuring has contributed to the enforcement of existing contract terms. As for the closure of
uncompetitive enterprises, market-based liquidation companies are not as prevalent as in countries
where bankruptcy and liquidation proceedings are more commonly utilized to reorganize companies and
restructure debts (such as in Hungary). In Poland, valuations are commonly conducted by engineering
or consulting firms, rather than bonding, insurance, or specialized liquidation companies. Because the
legal framework remains weak, there is still limited recourse for banks or enterprises to recover loans.
Consequently, to protect themselves against running up losses, banks (and enterprises) are less willing
to lend.33 The consensus is that Poland could remedy these weaknesses by (i) strengthening collateral
legislation for secured transactions by putting non-government creditors on an equal basis as government
creditors; (ii) updating the Commercial Code to provide faster in-court resolution to debt disputes,
permitting creditors to seize and resell assets quickly to cover at least part of delinquent debt; and (iii)
encouraging the market for private liquidators for the seizure and prompt sale of assets. Updating and
unifying registries will help, but these additional measures are needed to make the legal framework more
efficient and responsive to contract enforcement needs.

**Slovak Republic**

The current legislative framework for investment is based on the amended Commercial Code and
the Civil Code. The Commercial Code, which entered into effect in January 1992, provides an adequate
basis for the establishment of private businesses. However, its main weaknesses appear to lie in
implementation. In general, business rules regarding licensing, establishment and regulation of companies
provide a large role for the government, which strains developing administrative capacity. This is
particularly true regarding in-court and out-of-court capacity to resolve disputes.

Contract enforcement in the Slovak Republic is hindered by an often unclear Commercial Code,
leading to poor enforcement of contractual rights. Court capacity to resolve disputes and enforce
contracts is limited, as demonstrated by significant court backlog. Of the 306,000 cases presented in
1992, 174,000 were not resolved by 1993. Administrative and procedural delays contribute to the
backlog, partly because former state arbitrators who became judges in the shift to a market system did
so without the requisite exposure to commercial law and dispute settlement. A lack of exposure to extra-
judicial methods of dispute resolution likewise limits out-of-court procedures in contract enforcement
matters. Where the Slovak Republic has shown some success is with the role played by some market-

---

32 Most conciliation agreements have actually involved the transfer of assets to a new company (150
"commercializations") or conversion of debt to equity (60 cases). In some cases (although not most or all), there
has been some operational restructuring (reorganizing product lines, selling non-core assets, freezing/limiting wages,
letting redundant workers go). However, there is some evidence that the prevalence of conciliation agreements has
defered much needed operational restructuring at the enterprise level. About half the conciliation agreements were
concluded just before the required deadline (which may have simplified agreements rather than addressing complex
restructuring needs), and these agreements were subject to Ministry of Finance approval (which sometimes reversed
the commercialization option to retain state-owned status for the enterprise). It has been rare for banks to engage
in a market-based liquidation of seizure, valuation, and resale of assets to repay delinquent debt.

33 This has negative effects on pricing and trade credit as well. Enterprises increase prices on their
merchandise and services to provide up-front reserves against future uncollectible receivables. Also, enterprises
often insist on transactions being in cash or barter to eliminate credit exposure, limiting liquidity in the marketplace.
Based factoring firms.\textsuperscript{34} These firms have played a role in liquidating arrears in trade accounts (inter-enterprise arrears), important not only for general commerce, but in particular to resolve disputes between companies when CSFR became two separate countries. However, these firms are not the same as liquidation firms responsible for the seizure, valuation and resale of assets to pay down outstanding debts. Above all, weaknesses in the Commercial Code and legal infrastructure seem to have been problematic with regard to loan collection, which has become a key problem for many businesses and banks. About one in seven cases in the court system is related to loan collection, which would account for about 25,000 unresolved cases in 1993 among the 40,000-45,000 initiated in 1992.\textsuperscript{35} As in the Czech Republic, Slovak banks have virtually no financial incentive to initiate bankruptcy or liquidation proceedings to recover delinquent loans. Proceedings are time-consuming, and settlements rarely provide adequate coverage of the loss relative to the time and money spent attempting to recover principal and interest.

5. Bankruptcy and Liquidation

As in other areas of the legal framework, market economies have varying approaches to bankruptcy and liquidation with trade-offs in their implications for debtors, creditors, competition and market discipline. Some are highly protective of large-scale debtors (US), with new credit and ample time provided for reorganization, but often at high cost over long periods of time during which reorganization programs are reviewed and arbitrated. Other models are less protective of debtors (UK), reducing the costs and time needed for corporate reorganization, but also more quickly pre-empting that option in the first place. Still other models (Germany) rely on inter-locking directorates between banks and enterprises to sort out debtor-creditor disputes. Prior to 1990, the Visegrad countries (and other transition countries) had virtually no bankruptcy or liquidation procedures, largely because they were unneeded during the period of central planning. Since then, the Visegrad countries have shown mixed performance and approaches to bankruptcy and liquidation. Hungary has used court-led proceedings actively since 1992 in an attempt to provide transparent guidelines and automatic trigger mechanisms for contracts involving debtors in default. Poland has focused on out-of-court procedures to resolve debt disputes, with court-led bankruptcy and liquidation as additional options. By contrast, the Czech and Slovak Republics have been reticent in their use of bankruptcy and liquidation by court-led or out-of-court methods, deferring needed financial and operational restructuring of many troubled enterprises and banks. The main problems associated with adjudication have been (i) weak collateral claims and dual/multiple claims on the same assets/properties; (ii) uncertain values resulting from restitution claims and insufficiently developed secondary markets; (iii) problems with seizure (credit hierarchy) and resale; (iv) weak judicial infrastructure and time-consuming processes with uncertain results; (v) the fraudulent dissipation of assets prior to bankruptcy filings; and (vi) general social pressure against bankruptcy/liquidation for SOEs and other properties (housing), partly due to the traditional role of SOEs in providing social services. These collateral, institutional and social weaknesses undermine the use of bankruptcy and liquidation as a means of contract enforcement and dispute settlement. Meanwhile, secondary debt markets have been slow to develop in all four countries, depriving financial markets and the judicial branch of market-based solutions to debt disputes.

\textsuperscript{34} In 1992, the government contracted out a private factoring firm to account for inter-enterprise claims, net them out, and bridge-finance the net outstanding debt. This was done over a period of about one year, and helped identify the magnitude of (i) net indebtedness of loss-making enterprises in need of restructuring or liquidation; (ii) claims on former CMEA countries; and (iii) outstanding indebtedness to the Czech Republic.

\textsuperscript{35} Bank non-performing loan rates approximate 28 percent of total, and this could be an understatement due to loan rollovers from banks to troubled enterprises. At the trade level, suppliers now insist on cash/barter up front before transactions take place to protect against bad receivables.
Czech Republic

The Czech Bankruptcy Law (1991) (i) focuses on liquidation; and (ii) subordinates bank and trade creditors to a low position on the credit hierarchy. Consequently, it has not been widely used as a tool for corporate reorganization. Pre-bankruptcy debt collection includes foreclosing on collateral. However, this concept has not yet really developed in practice due to (i) undeveloped dispute resolution procedures; (ii) limited court capacity; and (iii) inexperienced liquidation/repossession companies. "Voluntary" debt write-downs have been legally restricted to creditors who are able to obtain a court order resulting from bankruptcy proceedings. However, few creditors (banks or enterprises) pursue this option because of the cost and time involved with bankruptcy proceedings.

Bankruptcy is undeveloped in the Czech Republic. Only a limited number of bankruptcy or liquidation cases have been litigated in court proceedings. Bankruptcy is triggered automatically, once company net worth becomes negative. However, creditors can roll over loans or provide additional funds to companies to keep them afloat to avoid write-offs and losses. Meanwhile, bankruptcy prompts bank write-offs without any guarantee that credits will be repaid. This indicates a bias towards liquidation, rather than as a tool for enterprise reorganization. The same is true for creditor enterprises (trade suppliers), which may be faced with legal costs plus write-offs of receivables. Out-of-court methods generally remain informal, subject to negotiations, and without any legal guarantees or transparency. Given the lack of development of bankruptcy and liquidation traditions in the Czech Republic, the rapid development of secondary debt markets could be very helpful in staving off large numbers of future bankruptcies and containing banking sector earnings declines. However, to date, there has been limited movement in this direction. While the Civil Code recognizes the transferability of a creditor's claims without the debtor's consent, banks have failed to develop this market, apparently to avoid sending market signals about loan portfolio weaknesses.

Hungary

Hungary has the most extensive institutional judicial capacity for bankruptcy and liquidation proceedings among the Visegrad countries, with more than 28,000 total filings by 1995 which have involved more than HUF 248 billion (about US$ 2 billion) in disputed debt. While the process to date has not succeeded in restructuring the largest of Hungary's loss-making enterprises, recent changes to bankruptcy legislation and greater commitment to privatization may reverse this trend.

According to the Bankruptcy and Composition Act (1991, 1993, 1994), debtors can petition for protection for a period of three months without appeal. An extension of an additional three months is permitted if a majority of creditors agrees. Creditor consent is determined by (i) a majority of votes based on the value of claims if the number of creditors is 15 or less; or (ii) through resolution of a creditor committee, based on a majority of votes (based on the value of claims) if the number of creditors exceeds 15. Claims are satisfied in the following order: (i) bankruptcy administration; (ii) employee claims (unpaid wages and benefits); (iii) tax arrears; (iv) customs and social security arrears; and (v) other claims.

A 1992 survey of 57,000 enterprises by the Ministry of Finance determined the following: (i) total debt of HUF 572 billion (then nearly US$7 billion), of which HUF 248 billion to banks, HUF 157 billion to GoH, HUF 127 billion to trade creditors, and HUF 40 billion to other creditors; and (ii) of the total sample, 602 enterprises (of which 306 were majority state-owned) were responsible for about 70 percent of total accounting losses, and probably about 70 percent of the debt. With total annual accounting losses of HUF 380 billion (9 percent of 1994 GDP) and soft budget constraints through 1994, total debt that could be resolved through court processes could easily have exceeded HUF 1,000 billion (about 25 percent of 1994 GDP).
The 1992 Bankruptcy Law was dramatic in reversing creditor passivity, attempting to counter soft budget constraints on problem borrowers by triggering formal court-led restructuring proceedings for indebted enterprises. The 1992 Law allowed a 90-day workout period (reorganization) after bankruptcy, or liquidation if a workout was not feasible. Between January 1992 and June 1993, 5,000 enterprises petitioned for reorganization, and banks petitioned for the liquidation of 13,000 indebted enterprises. In some cases, enterprises effectively restructured and banks imposed some financial discipline (to counter soft budget constraints on enterprises). However, in many other cases, enterprises liquidated after effectively pirating assets against which banks had no subsequent claims, leaving behind empty shell companies. Delays also occurred because of overutilized court capacity, which gave managers time to expropriate assets in advance of court settlements. Consequently, amendments were adopted in late 1993 to reverse 1992 weaknesses. However, some of these changes failed to correct 1992 weaknesses, namely (i) private liquidators were provided financial incentives to drag out the liquidation process over a full two-year reorganization period; and (ii) the lack of restrictions on legal appeals after filing for liquidation led to delays in the appointment of liquidators and provided more time for asset stripping. Due to these weaknesses, the average period to conclude the liquidation process has been two years. At the same time, out-of-court schemes proved to be unsuccessful due to excessive meddling by state agencies when negotiating the bankruptcy or liquidation of state enterprises. To make bankruptcy legislation more effective, Hungary plans to amend the Bankruptcy Law to (i) change fee remuneration for liquidators to provide incentives for more rapid liquidation; (ii) alter trustee remuneration in bankruptcy cases to reduce litigant costs; and (iii) reintroduce the automatic 90-day moratorium on debt service for enterprises filing for bankruptcy to provide them with sufficient time to prepare adequate reorganization plans. It is believed these changes will enhance the effectiveness of Hungary’s bankruptcy legislation, particularly if combined with aggressive privatization. Greater secondary debt market development would complement Hungary’s court-oriented approach to debt restructuring. Only a small number of transactions in secondary debt have occurred.

Poland

There is adequate flexibility in Poland’s legal framework to encourage in-court as well as out-of-court settlements. Much of the problem associated with in-court processes has to do with the overlap

38 Reorganization (restructuring) allowed management to stay in control of the debtor’s assets as long as it came up with a plan within 60 days to restore enterprise solvency. The plan had to be approved by all creditors at a hearing. Liquidation could be initiated by creditors or debtors, with reorganization becoming liquidation if no agreement was reached within 90 days.

39 Changes in 1993 included (i) making bankruptcy filing optional for enterprises with debts more than 90 days in arrears; (ii) reducing the required 100 percent creditor approval to two thirds debt value and half of claimants; (iii) changing the automatic 90-day moratorium on debt service; (iv) raising compensation levels for liquidators; (v) requiring trustees to oversee reorganization; and (vi) allowing debtors to reorganize every two years.

40 The September 1993 amendments to the Bankruptcy Law reduced the number of bankruptcy and liquidation filings. However, insufficient court capacity is indicated by the statistics: of nearly 23,000 liquidation filings through 1994, the courts had rendered judgments on about 7,200 (about one third). Of these 7,200 judgments, only 2,850 had been definitively concluded (about one in eight filings).

41 1990 amendments to the 1934 Bankruptcy Law allow the reorganization and liquidation of enterprises through in-court procedures. Courts, debtors or creditors can initiate bankruptcy proceedings. Creditor-initiated proceedings require creditors to demonstrate that the debtor cannot pay debts, and the enterprise must be large (continued...)
in legislation and institutional actors. Polish legislation regarding bankruptcy, liquidation and reorganization dates back to 1934, with amendments and newly adopted laws extending into the current transition. These laws apply to all commercial entities apart from entities considered significant to the state, where special powers are granted to state authorities. Difficulties associated with collateral and institutional capacity remain the most problematic issues for creditors and debt settlement. This has been particularly true with large SOEs forestalling on the repayment and servicing of outstanding loans, and the resulting impact it has had on the allocation of bank credit. Of the nearly 800 debt restructurings under the Enterprise and Bank Restructuring Program, only 171 were conducted in court to resolve OZ 2 billion (less than US$ 100 million). With three-quarters of bankruptcy and liquidation decisions initiated by non-bank creditors (about 125), it appears that banks were unwilling to enforce their semi-judicial powers despite having the authority to do so. GoP intends to revise bankruptcy legislation and regulations to (i) suitably direct disputes to in-court or out-of-court institutions; (ii) modernize in-court procedures; (iii) introduce appropriate fees; (iv) clarify the role of trustees in dispute resolution proceedings; and (v) set guidelines for time to be spent resolving disputes.

Out-of-court processes are more developed in Poland than in other Visegrad countries, largely because of legislation which adopted formalized timetables for dispute resolution. The Financial Restructuring of Enterprises and Banks Law (1993) gave semi-judicial authority to the banks to resolve debt disputes with borrowers, including the authority to conduct enterprise reorganization as long as creditors accounting for at least 50 percent of the debt value agreed with the restructuring plans. The law also permitted debt-equity swaps (subject to capital ratios) and debt sales into the secondary market. All together, out-of-court settlements through mid-1994 resolved about 200 disputes comprising one-third (OZ 7.6 billion, or US$ 300-350 million) of the stock of the nine affected state banks' non-performing

41 (...continued)


43 In Poland, there were 6,300 loss-making SOEs which accounted for 45 percent of bank debt and 40 percent of inter-enterprise debt (end 1991). However, more than half of losses (and bad debts) were attributable to about 100 of Poland's largest SOEs. Thus, as in Hungary, there was a high concentration of bad loans in the large SOE sector.

44 Banks have shown little inclination to take risk and increase lending to viable enterprises, instead investing in government securities (see Section IV). One of the major reasons for not increasing lending to viable enterprises is the cost, time and uncertainty regarding the exercise of collateral rights through bankruptcy or liquidation proceedings.

45 Court supervision was an option if an appeal was made. However, the rationale for using out-of-court methods was to avoid overwhelming the court system with reorganization and restructuring cases.
loan portfolios through 1993. However, as in the other Visegrad countries, out-of-court processes suffer from insufficient capacity for fast processing. To make bankruptcy and liquidation work more efficiently, most observers believe Poland needs to (i) centralize and automate property registries (in process); (ii) increase institutional capacity (in- and out-of-court) and information flows to accelerate dispute resolution; and (iii) provide banks with recourse to assets pledged as collateral, which is directly linked to improved property registries and the elimination of multiple claims on assets. In addition, secondary market development for assets requires a more accurate valuation system in place for reorganization, liquidation and settlement. This could be significantly improved with emergence of a secondary market for debt, which is expected to grow but has shown only preliminary development to date.

Slovak Republic

The Slovak Republic inherited the Bankruptcy and Composition Act from the CSFR (1991), and subsequently added amendments (1993). Like the Czech Republic, the Slovak Republic remains reticent in its use of bankruptcy and liquidation as a means of contract enforcement and corporate reorganization. Weaknesses in the Bankruptcy Law include: (i) each creditor has one vote regardless of financial stake; (ii) foreign creditors are not permitted to initiate conciliation (reorganization) proceedings, or be part of creditors’ committees or meetings; (iii) any creditor can legally challenge enterprise workout plans resulting from conciliation proceedings; and (iv) certain enterprises and all SOEs are exempt from the Bankruptcy Law, which means only the government can liquidate these enterprises.

As in the Czech Republic, bankruptcy proceedings are undeveloped in the Slovak Republic. Weaknesses in the Bankruptcy Law serve as a deterrent to debtor reorganization as all creditors need to agree on a restructuring program. The Bankruptcy Law leaves limited flexibility to creditors, providing them with two options: roll over outstanding loans to problem enterprises, or liquidate the enterprise. As the net worth of the enterprise is negative by the time bankruptcy proceedings are initiated, creditors tend to roll over loans to keep the troubled enterprise afloat to avoid write-offs on their own financial statements. In the case of SOEs, which are exempt from the law, creditors (state banks) have traditionally provided them with steady credit flows regardless of solvency. More recent credit data indicate banks have slowed lending flows to troubled SOEs, but that government subsidies have increased (see Section IV). This has provided a basis for deferring needed restructuring in both the enterprise and banking sectors, rather than using bankruptcy as a tool for reorganization. The Bankruptcy Law provides for liquidation and compulsory settlement, while 1993 amendments introduce mandatory conciliation between a debtor and its creditors. A conciliation agreement becomes binding if it is concluded before a bankruptcy order is issued by the court to all creditors. However, to date, there has been little use of bankruptcy. Legal obstacles in arriving at suitable reorganization agreements are compounded by enforcement weaknesses due to limited court capacity and authority (exposure to commercial law, repossession), lack of familiarity with conciliation and bankruptcy (judges), and deficient information systems and technology (property registers, credit history). In light of these obstacles, many observers believe reforms are needed to accelerate out-of-court conciliation procedures (binding arbitration) to (i) facilitate resolution of contract disputes (Commercial Code); and (ii) reduce case backlog. This could be done by (i) simplifying administrative procedures; (ii) increasing training/exposure of judges to commercial law; (iii) establishing rules for fair credit reporting (including debt service) and ratings; and (iv) encouraging non-bank financial institutions (NBFIs) to play a greater role (credit ratings, liquidation procedures). Specific reforms could include (i) bank-led workout agreements through negotiations with creditors and owners (often managers/employees); (ii) a general framework of laws governing contracts; and (iii) an amended Bankruptcy Law to permit enforcement of agreements reached by a majority of

---

46 The Enterprise and Bank Restructuring Program resulting from the law originally covered OZ 15.75 billion (about US$ 700 million) in SOCB non-performing loans. This was about two-thirds of total bad bank debt of the nine affected banks at the time. Out-of-court settlements accounted for half the value and one-quarter of the projected 792 debt restructurings.
creditors, rather than all creditors.\textsuperscript{47} In addition to in-court and out-of-court processes, banks and NBFIs should be encouraged to develop \textit{secondary markets for debt}.

C. Regulation and Competition in the Visegrad Countries

1. Introduction

The Visegrad countries have demonstrated varying levels of openness in terms of \textit{trade} and \textit{investment}, but generally have pursued reforms with the intention of harmonizing their laws with those of the European Union. Some level of tariff protection has been provided for domestic producers, although this is required to decline in the coming years as GATT/WTO and Association Agreements with the European Union come into effect. Remaining obstacles to open competition in the financial services sector (delays in issuing licenses for new banks, barriers to entering the life insurance market) are also required to decline in the coming years, and foreign financial firms are already increasing their presence and market activity in the Visegrad countries. In general, there has been a trend towards liberalization of trade and investment since 1990. As for \textit{natural} monopolies, the Visegrad countries have shown some progress towards demonopolization and privatization. Privatization is starting to increase in the telecommunications, electricity, and oil and gas sectors. Road construction and transportation have been increasingly open for the last several years. The Visegrad countries have demonstrated a willingness to partially privatize their airlines. Poland has made strides towards port privatization, and Hungary has indicated interest in at least partial privatization. Various water utilities are also soliciting private participation. However, demonopolization and privatization have proceeded at different rates, with Hungary and the Czech Republic moving more quickly than Poland or the Slovak Republic. The state remains engaged in virtually all of these sectors, allowing only partial privatization to date in most areas where private participation has been introduced.

2. Customs Regulations and Trade

In general, the Visegrad countries have done much to open up their economies to free trade. The Visegrad countries today follow a four-tiered approach to import trade as follows: (i) base rates for imported goods from GATT/WTO countries; (ii) higher rates for those which do not have most favored nation status (MFN) with the Visegrad country; (iii) preferential rates for developing countries and least developed countries under the Generalized System of Preferences (GSP); and (iv) the lowest rates for countries with which it has special agreements (CEFTA, EU, EFTA). Most non-tariff and tariff \textit{import barriers} have been removed, as demonstrated by the significant increase in imports since 1990.\textsuperscript{48} Most

---

\textsuperscript{47} If creditors fail to reach agreement, the enterprise could go to court-led bankruptcy or liquidation proceedings. However, efforts could be made to keep court involvement to a minimum. Court responsibilities could involve notification of all creditors, verification of property titles and collateral, and observance of time limits for creditor appeals. Rather than further burdening the overburdened court system, an extra-judicial \textit{"workout and mediation facility"} for enterprises to access needed skills could be provided to assist with workouts, restructurings and agreements.

\textsuperscript{48} This statement is made on a qualified basis. Hungary, Poland and the Slovak Republic still have import surcharges. Nevertheless, these are lower than the tariffs applied prior to the transition period, and each of the governments has stated the intention of reducing these surcharges and ultimately eliminating them. In Hungary's case, the import surcharge was introduced in March 1995 to contribute to economic stabilization after having significantly liberalized its trade regime and opened its domestic markets to competition. The surcharge could be removed in 1997, although this will depend on the results of its stabilization program. Poland's import surcharge largely applied to the troubled agricultural sector. More recently, Poland has begun to shift its strategy to reduce

(continued...)
domestic price controls have been removed, although some remain for fuel, transport, rent, pharmaceuticals, public utilities, health services, school books, milk, bread, alcohol, cigarettes, and television fees. The use of export taxes and quotas have been widely circumscribed as the Visegrad countries have moved away from administered trade. Monopolies still exist, but privatization and private sector development have stimulated competition, reducing monopoly positions in most sectors. However, there is still a weakness in the Visegrad countries in this domain. Many trade companies which originated as foreign trade operations during the period of central planning have been able to protect their positions as caretakers of "strategic" assets and resources, shielding themselves from needed competition. Trade legislation is also considered somewhat protectionist in some countries (Poland, Slovak Republic) where industrial restructuring of state enterprises has been slow to occur, although this is changing due to EU Association Agreements.

The most significant influence regarding trade has been the signing of multilateral trade agreements with the EU, EFTA and CEFTA, which account for about 75 percent of total Visegrad trade. These agreements and trends are expected to provide incentives to the Visegrad countries to pursue market reforms and trade liberalization. The Interim Agreements on Trade and Trade-Related Matters (ITAs) for each Visegrad country with the European Union provide for (i) free trade in industrial products (including mineral fuels, ores, and metals, but excluding textiles, iron, and steel, which can still be subject to quotas) in five years for the EU and 10 years for the Visegrad countries; (ii) improved access for some agricultural products (excluding cereals), while action on other products remains subject to the Uruguay Round and the reform of the CAP system (with the increase in agricultural imports limited to 10 percent for each of the following five years); (iii) a commitment on the part of the signing Visegrad country to harmonize its economic legislation with that of the EU; (iv) a commitment on the part of the EU to provide financial and technical assistance (without specifying amounts); and (v) possible (eventual) introduction of free trade in services. The EU made additional concessions in the Copenhagen Summit in June 1993, speeding up the liberalization process in many products. The summit (i) brought forward by two years the lowering of the weighted average tariff on imported goods from 4 to 2 percent; (ii) increased annual export ceilings of remaining industrial products by 10 percentage points (excluding textiles and steel); (iii) provided for the elimination of duties on steel, textiles, and clothing by 1996 (rather than 1997); and (iv) advanced the scheme for agricultural products by six months. Table 2 highlights targeted timetables for free trade between the Visegrad countries and EU members by sector.

---

(...continued)

surcharges and tariffs on primary goods while maintaining some protection on finished goods. This provides its processing and export-oriented industries with pricing advantages. The Slovak Republic has stated its intention to keep its surcharges in effect until at least mid-1996, although there is pressure to ease in light of the country's trade surplus in 1994.

Trade with the EU accounts for an average of 50 percent for Visegrad countries, while the share of EFTA is another 15-20 percent. The share of CEFTA trade for each country, in contrast, is at an average of 5 percent.
Table 2: EU Association Agreement Timetable for the Visegrad Countries

<table>
<thead>
<tr>
<th></th>
<th>Agriculture*</th>
<th>Industry**</th>
<th>Services***</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>EU</td>
<td>Visegrad</td>
<td>EU</td>
</tr>
</tbody>
</table>

* Includes all agricultural products except cereals; dates refer to limited concessions. ** All industrial products except textiles and clothing. *** All services except for air transport, inland waterway transport and maritime shipping. EU means date of free entry for Visegrad products into EU markets; Visegrad means date of free entry of EU products into Visegrad markets.

Sources: EU Association Agreements.

The EFTA trade agreement abolished tariffs and non-tariff barriers for 85-90 percent of exports from each Visegrad country, which are expected to reciprocate with similar reductions in five to 10 years. The CEFTA agreements were aimed at liberalizing trade in "sensitive" products (steel, textiles, agriculture) by 2003, and in "normal" products by 1998. Duties on agricultural products are to be eliminated in by 1999, but quotas will remain. More recently, foreign trade ministers from the CEFTA countries announced they (i) planned to accelerate trade liberalization in industrial goods categories;50 (ii) a similar agreement would be announced for agriculture; and (iii) CEFTA would admit new members, with Slovenia likely to be the first non-Visegrad member of CEFTA.51 While CEFTA is a "symmetric" agreement, in that all parties are expected to reduce their protection levels equally over the same period, those with the EU and EFTA are "asymmetric", giving the Visegrad countries more time to reciprocate.

**Czech Republic**

The Czech Republic began to liberalize trade in 1990. By 1991 most quotas, quantitative targets, and non-tariff barriers were lifted. Quotas were not substituted by equivalent increases in tariffs.52 As a result, the average nominal tariff protection was 8 percent in 1991, including a 2 percent average charge on consumer products if applied to all imports. By 1992, the average rate was down to 6 percent, where it remains today based on average unweighted nominal tariff protection figures (ad valorem).

**Price controls** have generally been abolished. Price regulation is practiced only for public utilities, and covers about 5 percent of GDP. As of May 1994, only 14 items were subject to price regulation: (i) maximum prices for natural gas, electricity, central heating, post and telecommunications, railroad passenger tariffs, bus passenger tariffs, rents in non-cooperative apartments, medicine, health services, and gasoline; and (ii) substance-based (based on inspection of cost and profits) prices related to water supply, producer prices for gasoline, heating oil and central heating, and urban public transport.

50 This means (i) "medium sensitivity" goods (chemicals, some machinery and equipment, wood and paper) will be tariff-free from January 1996; (ii) "particular sensitivity" goods (textiles, footwear, some steel and electronics products) will be tariff-free from January 1997; and (iii) "most sensitive" products (cars, other goods) will be tariff-free by 2002, to coincide with the deadline set in EU Association Agreements for free trade in industrial products.

51 Bulgaria, Romania, Estonia, Latvia and Lithuania are likely to become members later.

52 Import licenses were required only for oil, natural gas, sporting guns, ammunition and explosives.

25
Export taxes have also been abolished, with export controls on armaments, explosives and petroleum products now exercised by Ministry of Industry and Trade. Controls on antiques are administered by the Ministry of Culture.

The process of liberalization has been accompanied by a series of bilateral and multilateral trade agreements to integrate Czech trade with market economies. In 1988, the former Czechoslovakia signed a four-year agreement governing industrial products with the European Community. An agreement giving the CSFR easier access to EU markets and technology was signed in May 1990. In December 1992, the Czech Republic (CSFR) signed the Central European Free Trade Association (CEFTA) agreement with other Visegrad countries, which provides for the establishment of a free trade zone by Jan 1, 1998. The Czech Republic also signed trade agreements with the EU and EFTA, each envisaging a free trade zone. The trade component of the Czech Republic’s Association Agreement with the EU became effective in March 1992, while the Association Agreement in its totality became effective in February 1994. The EFTA agreement came into effect in July 1992.

Hungary

Hungary introduced measures to liberalize its trade regime beginning in 1989. Under its present import trade structure, Hungary applies mostly ad valorem rates, averaging 13 percent (unweighted), and an additional (temporary) 8 percent surcharge, bringing the tariff rate up to about 20 percent.\(^3\) There is wide dispersion among the rates applied to different products, with some tariff rates reaching 50-60 percent, while others can be as high as 120 percent. Zero-rating is applied to exports under the Value Added Tax (VAT) system.

Price controls have been gradually phased out for most goods and services. By 1992, there were few price controls left: (i) maximum prices for fuels (not oil), school books, milk, white bread, transport, post office services, government-owned housing rentals, water, heating, television fees, and pharmaceutical profit margins; and (ii) minimum prices for wheat, maize and certain meats. Even household electricity rates have recently been increased to more accurately reflect real costs. The share of its hard currency imports free of licensing requirements rose from 40 percent in 1989 to 80 percent in 1991 and 90 percent in 1992. More than three-quarters (78 percent) of Hungary’s exports are free of licensing requirements. Most of Hungary’s economy is open to competition, although some evidence of monopoly remains. Special government concessions are required for investment in telecommunications networks and services, transport infrastructure (roads, railways, harbors, airports, trains) and haulage, electric power stations and powerlines, extraction of natural resources, pipelines, radioactive products, pharmaceuticals, gambling, and postal services.

The fiscal impact of the free trade agreements with Europe is more pronounced for Hungary than for the other Visegrad countries. Hungary relied heavily on foreign trade taxes for budgetary revenue (3.5 percent of GDP in 1992). As a result of the agreements it has signed with the EU, EFTA, and GATT, Hungary will abolish duties on (i) "non-vital" products (those which it generally does not produce domestically) by end 1995; (ii) on other goods for which there is domestic production from 1995-1997; and (iii) on all protected goods from 1995-2002. As a result, state revenues from trade are expected by GoH to fall by 10 percent in 1995, 20 percent in 1996, 30 percent in 1997-1998, and 40 percent by 2002. The temporary 8 percent import surcharge will also be eliminated. Meanwhile, the ratio of trade tax revenues to the value of imports has already declined, from 8.9 percent in 1990 to 3.2 percent in 1994. Thus, trade liberalization should have a major impact on overall production in Hungary (as elsewhere), with significant fiscal consequences at a time when Hungary is redoubling efforts to achieve fiscal stability. The ITA with the EU is projected by GoH to increase the share of Hungary’s merchandise

\(^{3}\) The average unweighted nominal tariff protection was 16 percent in 1990, lower than today.
exports entering the EU from 62 percent in 1992 to 78 percent in 1997, while the duty-free portion of total Hungarian exports would increase from 48 percent to 69 percent during this period. The increased volume of export trade should help Hungary recoup some of the lost revenues from earlier taxes on imports.

**Poland**

The trade reform process began in 1990, when Poland abolished state monopolies and the administrative management of foreign trade, and moved to a more transparent system from quotas to duties. Initially, trade liberalization was used to combat inflation, whereby international prices were allowed to affect domestic prices. Most non-tariff restrictions were abolished in January 1990. In June 1990, duties were eliminated on 4,500 items, and the average tariff was reduced to 5.5 percent. However, as inflation was brought under control after 1991, tariff suspension was withdrawn. This raised the trade-weighted MFN-basis tariff to 13 percent. Currently, a border tax of 5 percent is applied to all imported goods. Duty rates range from zero to 75 percent, but most fall within the 4.3 percent to 18 percent range. In July 1993, Poland revised its tariff structure, reducing duties on imported raw materials and semi-finished products while increasing those on finished products, thus increasing the effective rate of protection for some manufacturing industries. This has resulted in a wide range of rates, and a partly protected industrial sector which is strengthened by increased use of preferential rates for inputs. In keeping with the GATT/WTO and EU Agreements, average tariffs dropped in January 1995 from 10.78 percent to 9.33 percent for manufactured goods, and from 20.04 percent to 19.52 percent for agricultural goods. Import surcharge rates have declined steadily, from 8 percent in 1992 to 5 percent in 1995, and an estimated zero percent in 1997.

*Price controls* exist only on a few goods or services in Poland. By 1992, most prices were deregulated, except for administratively set prices (electricity, gas, central heating, hot water, rents in local government-owned housing, television fees, spirits) and prices affected through taxes (beer, wine, cigarettes). Changes in these prices can be amended by the Council of Ministers. Poland has no export taxes.

While most goods and services are freely tradeable in Poland, there are some trade restrictions which protect *monopoly* positions: (i) concessions are required for and import quotas are applied to alcoholic beverages (wine, when alcohol proof exceeds 22 percent, other fermented beverages, alcohols used to produce liquors), tobacco products, and petroleum products (gasoline, diesel fuel, heating oils); (ii) licenses are required for dairy, alcoholic beverage, tobacco and petroleum product exports; and (iii) licenses are also required for imports of gas, dairy products, alcoholic beverages, poultry, leased machines and transport equipment. Imports of delivery vans older than 10 years, trucks older than 6 years, and two-stroke engine cars are forbidden. Pure alcohols, spirits and certain alcoholic beverages are likewise forbidden. A license or permit is required for undersea natural resource extraction, non-
ferrous metals, wholesale trade in tobacco and alcohol, poisonous and toxic substances, weapons, explosives, air transport, international land transport, sound and vision on tapes, records, cassettes, films, mail services, and gambling.  

Poland began its trade negotiations with the European Community in 1989, and received GSP status for some goods in January 1990. Poland entered an Association Agreement with the EU on March 1, 1992. Under this agreement, Poland is required to remove duties on 27 percent of EU imports (mainly raw materials, semi-finished products, capital equipment) to reciprocate for the EU's removal of duties on most Polish goods exported to EU countries. By 1999, all duties are required to be removed to establish a fully consolidated free trade zone. More significantly, ratification by Poland in 1995 of the new GATT/WTO conventions will alter Poland's customs regulations and harmonize them with international standards. Poland's EFTA agreement, signed in 1992, came into effect in November 1993.

Slovak Republic

The Slovak Republic has applied an import tax surcharge of 10 percent on consumer goods since February 1994, down from the 20 percent surcharge introduced in 1991. GoS has decided to retain the surcharge until at least mid-1996, despite a merchandise trade surplus in 1994. The VAT is applied to imported goods, re-imported goods which have been exported to further processing, and re-exported goods which have been imported for temporary use at 25 percent for most goods. Duty-free imported goods are free of the VAT, and no VAT is applied to exports.

Import licenses are required for certain goods, such as oil, natural gas (including liquid gas), sporting guns, ammunition, and explosives. Export restrictions apply to glass, antiques, and porcelain. Price controls are applied to transport (railways), fuel and energy, telecommunications, housing rentals, and basic food products such as meat and milk on a seasonal basis. Export licenses are required for a limited number of goods and services for (i) health reasons (livestock, plants); (ii) to facilitate voluntary export restrictions on products subject to import quotas abroad (textiles, steel); and (iii) to preserve natural resources (energy, metallurgy, wood products). In some cases, such as the export of foodstuffs, pharmaceuticals and construction materials, conditions may be unnecessarily restrictive.

The Slovak Republic has liberalized trade on 20-25 percent of its goods imported from the EU, with complete tariff removal expected by 2002. Some observers believe the favorable impact of the Slovak Republic's Association Agreement with the EU is somewhat constrained because those products excluded from the liberalization scheme occupy a significant portion of its trade with several EU partners. On the other hand, despite the slow pace of privatization (since 1993) and the prevalence of quotas, textile exports to market economies have doubled between 1990-1994.

3. Labor Markets

The Visegrad countries have shown progress in the areas of labor relations. Some labor protection remains as the Visegrad countries have moved toward tripartite approaches which (i) set compensation levels; (ii) clarify social benefits; and (iii) establish workplace rules and safety standards. Nevertheless, the consensus appears to be that this approach is far more flexible than the paternalistic approaches which characterized the central planning era. Furthermore, these agreements are often predicated on company requirements to be competitive, and thus appear to be based increasingly on higher productivity standards and less on entitlements.


For example, Austria, France, Germany, Italy and the UK account for 16 percent of Slovak textile and clothing exports and 12 percent of steel and iron exports.
Czech Republic

Labor market relations and regulations in the Czech Republic are governed by the Labor Code (1965) and subsequent amendments. As in the other Visegrad countries, a tripartite collective bargaining system setting wages and addressing working conditions was established in the Czech Republic by 1994. According to the Labor Code, a written work contract is required for employment for longer than three months. Unless the contract specifies a fixed term, it is valid for an unlimited term. The contract can specify a probationary term between one and three months. The Labor Code also provides procedures for employee dismissals. The Code and amendments are a departure from earlier practices, but remain somewhat protective of labor, making it difficult to release employees unless there are major disruptions, or the company needs to engage in major restructuring or dissolution. With low unemployment rates, many experts believe these issues have not been tested in the Czech Republic. In fact, one of the reasons behind the Czech Republic's low unemployment rates is the difficulty firms face in releasing redundant personnel, reducing productivity and competitiveness. What remains to be seen is how the approach to labor relations will be managed when companies do engage in needed restructuring, prompting some layoffs. Absent "major" restructurings or liquidations, the Code could conceivably protect many unneeded jobs. This is quite possible in the industrial sector, where the introduction of labor-saving technologies needed for companies to be competitive could displace thousands of jobs. Difficulties associated with labor during enterprise restructuring could ultimately make or break investment decisions. The Czech Republic imposed wage controls in the form of punitive taxes on firms that raised wages by an amount more than 5 percent above the inflation rate. These taxes were introduced in 1993 as a response to the rapid increase in wages and prices. However, in early 1995, these fines were reduced from 200 percent of the "excess wage" to 50 percent, and then subsequently abolished in July 1995.

Hungary

Hungary's labor legislation and practices were altered with Labor Code reforms which (i) reduced GoH involvement in labor-management relations; (ii) added flexibility to employer decision-making, including the release of employees with just cause; and (iii) instituted a tripartite approach to dispute resolution between labor and management, not uncommon among the other Visegrad countries. The new Labor Code, which came into effect in July 1992, requires that certain terms be included in the contract (job title, function, salary, benefits, workplace conditions), while other contract conditions are to be negotiated freely between employers and employees. The Code also introduced new conditions for extraordinary notice (for release of an employee with cause) for an employee, and shortened the notice period. Hungary's Interest Conciliation Council generally sets the minimum wage each year, mediates disputes, and administers the independent health and pension Social Security Funds. More recently, GoH has pursued austerity measures and modified the Labor Code to accelerate needed economic reforms. Nevertheless, many of the proposed reforms in the "austerity" budget announced in 1995 regarding wages

---

59 An employment contract can be terminated through (i) agreement (which should be written); (ii) notice (which, if given by the employee and with a two month advance does not need to include reasons; if given by an employer, needs to satisfy specified reasons in the law such as dissolution of the firm or major restructuring); (iii) immediate cancellation (which requires no reasons if submitted by an employee and accompanied by documented health reasons; if given by employer, requires reasons related to crime or workplace disruption, provided the employee has been warned in writing before); or (iv) termination during the probationary period specified in the contract (which requires no reasons). While employees are protected from arbitrary dismissals due to pregnancy, compulsory military service, or short-term health problems, the Code does permit dismissals due to major enterprise restructuring. Redundant employees receive a severance pay equivalent to two months' wage.
and benefits\(^6^0\) and layoffs\(^6^1\) were later ruled unconstitutional. Social entitlements have made Hungarian labor more costly to companies, and many experts believe this has deterred formal hiring.

**Poland**

Poland's labor laws\(^6^2\) govern (i) contract duration and types of work to be conducted; (ii) employee dismissals and severance pay requirements; and (iii) social insurance contributions, equivalent to 48.5 percent of wages (and deductible from corporate income taxes). The former system was replaced with *tripartite collective agreements* in conjunction with the Enterprise Pact to stimulate privatization in a manner acceptable to workers. A revision of the Labor Code introduced in late 1994 encourages collective bargaining. Wage controls have been relaxed,\(^6^3\) although the new tripartite system places negotiated limits on government, unions, and management. While firms exceeding these limits do not face sanctions, directors of firms can be fired or fined if wage increases are shown to harm the firm's financial status. Additional measures have been taken to address social issues and entitlements. An amendment to the Social Security Law (February 1995) restricts short-term employment exempt from social security taxes to prevent firms from using these contracts to avoid paying social security taxes. The Amendment (i) limits the maximum duration of untaxed contracts to 15 days (down from 30 days previously); (ii) mandates that successive contracts have to be 60 days apart; and (iii) taxes the combination of salary and contract payments. Further revisions to the Labor Code (March 1995) (i) require private and public firms to cover the costs of the first 35 days of sick leave at 80 percent of the normal salary; and (ii) allow both mothers and fathers to take leave for a sick child. These measures are largely bypassed by the informal sector, and are not fully adhered to by much of the formal private sector because of restrictions placed on managerial freedom, and the imposition of what are perceived to be costly entitlements and contractual mandates which drive up operating costs.

**Slovak Republic**

As found in the other countries of the region, the Slovak Republic has introduced a *tripartite approach to labor relations*. Tripartite agreements were first concluded in 1991 and 1992 in an attempt by the government to contain inflation based on wage growth. Trade unions, which are organized according to branches of industry, enter into yearly collective agreements with employers in most companies. While not compulsory, union membership is high. Trade unions are united by the Confederation of Trade Unions that takes part in regular tripartite meetings with GoS and the Union of Employers. While collective bargaining has become easier, the trade unions have lost some of the previous influence on government policy which they exerted in the past regarding wages and management of businesses. Wage rates and salary controls were lifted as of January 1, 1993. Nonetheless, the government retains the authority to regulate wages by decree based on the December 1993 Budget Law. In June 1994, GoS adopted a regulation which imposes tax penalties on loss-making state-owned

---

\(^6^0\) These include (i) removal of most child care benefits except for the poorest and largest families; (ii) payment of state sick pay after 20 days of illness instead of five days; and (iii) introduction of a 44 percent social security contribution on earnings from freelance writing activities. Total savings from these measures would have been HUF 35 billion (about US$ 245 million), or 20 percent of targeted savings from the austerity budget.

\(^6^1\) GoH redundancies at the television company and in universities were outlawed by the Constitutional Court.


\(^6^3\) The Wage Control Tax Law ("Popiwek Law"), effective August 1, 1994, allowed GoP to fine firms up to 150 percent of "excessive" wage increases.
enterprises with nominal wage growth exceeding targets set below the rate of expected inflation. The penalty, which became effective in July 1994, was not applicable to profitable companies, with the exception of those in banking, insurance, and energy sectors.

4. **Investment and the Financial Sector**

The Visegrad countries have shown progress in financial sector development. However, despite progress in all four countries, banks and capital markets remain troubled by persistent structural weaknesses and limited markets. Banks still appear to have high levels of non-performing loans. Net lending flows to the private sector have declined in Hungary and stagnated in Poland (see Section IV). Stock markets are low in capitalization by world standards. Institutional investors have been slow to emerge (Hungary, Poland) and are relatively small (Czech, Slovak Republics). Bond markets are underdeveloped (Czech, Slovak Republics) or dominated by the government sector to finance high levels of debt and fiscal deficits (Hungary, Poland). Thus, the Visegrad countries have all made progress. Yet, fixed investment rarely exceeds 20 percent of GDP, and therefore remains low compared to needed resources to be globally competitive.

**Czech Republic**

The Czech financial sector has made a significant contribution to investment and privatization, although structural weaknesses persist in the banking sector and capital markets, which still have far less activity than found in high-growth economies. Financial intermediation rates are 68 percent, the highest among Visegrad countries and respectable by global standards. Net lending flows to the private sector have increased steadily, and now account for about two-thirds of bank lending (see Section IV). However, high levels of concentration and non-performing loans among the formerly state-owned banks threaten to undermine some of the seeming stability of the investment climate (comparatively low interest rates, access to credit for the domestic private sector). As these banks were partly privatized by voucher, and because the state continues to hold a blocking minority share in almost all "privatized" banks, the corporate governance and lending practices of the banks still seem to be problematic. This is particularly true given the dispersed nature of bank shareholdings, and the limited ability of IPFs to provide real guidance to banks on the needed restructuring of troubled enterprises in bank loan portfolios. With competition already increasing in advance of 1999 (when EU Association Agreements governing the financial sector come into effect), most analysts believe it will be necessary for Czech banks to more openly and transparently address these problems if they are to be major market players in the financial sector.

---

64 Key legislation in the financial sector has involved the (i) Foreign Exchange Act (1990 plus three amendments); (ii) Bonds Act (1990 plus two amendments); (iii) Commercial Code (1991 plus five amendments); (iv) Insurance Act (1991 plus one amendment); (v) Banking Act (1992); (vi) Investment Companies and Investment Funds Act (1992 plus one amendment); (vii) Securities Act (1992); (viii) Stock Exchange Act (1992 plus one amendment); (ix) Income Tax Act (1992 plus several amendments); and (x) Czech National Bank Act (1993 plus two amendments).

65 The four largest banks in the Czech Republic account for about 65-70 percent of balance sheet values. With non-performing loans estimated to be 25-30 percent and the loss of blue-chip business to more competitive foreign banks, formerly state-owned banks are likely to face solvency and liquidity pressures.

66 This is true except for Zivnostenska Banka (ZB), originally the foreign exchange bank for individuals and travel agents, which is 52 percent-owned by Berliner Handels-und-Frankfurter Bank and the IFC. ZB accounts for only about 2 percent of loans and deposits in the Czech banking system.
As for capital markets, the Czech Republic has achieved a great deal within a short period of time. Legislative reform for developing securities markets began in 1990, when the government passed a new law on bonds, allowing the first bonds to be issued by companies and banks. At end September 1995, the bond market was valued at about US$ 3 billion with 49 issues. Monetary and fiscal stability combined with a commitment to rapid privatization have prompted the emergence of a buoyant equities market, as reflected in stock market capitalization figures that are 3-12 times higher than the other Visegrad countries (as a percent of GDP). Both bond and stock markets have been boosted by favorable reviews by international credit rating agencies. The Prague Stock Exchange (PSE) began to trade in April 1993. With more than 350 (primarily local) investment funds (IPFs) and emerging insurance and pension funds, the Czech Republic has established the building blocks for institutional investors to

Equities markets grew quickly in the Czech Republic. PSE attracted 72 percent of the vouchers from the first wave, and 65 percent from the second. The shares of some 850 companies privatized in the second wave began to trade on the PSE in early 1995. In June 1995, nearly 1,700 shares were traded on the PSE, of which 52 were listed, with a total market capitalization of US$14 billion. Much of the trading derives from the unofficial market (the RM-System), a nationwide network of trading centers established as part of the first wave of privatization. Unlike the PSE, the RM-system has a continuous auction system, and accounts for 60-80 percent of total turnover. PSE moved to daily trading on September 19, 1994.

More than 1,700 companies' stocks have been brought to market since 1993. This is far higher than the other three Visegrad countries.

Ratings as of September 1995 were: (i) Moody's: Baa2; and (ii) Standard and Poor's: BBB+ with a "Positive" outlook.

Requirements for listing include minimum capital of K 100 million (US$ 3.5 million), a two-year company history, and a minimum share offering of 20 percent.

Legislation passed in 1991 set the regulatory framework for the insurance sector, with subsequent Ministerial decrees to fill in gaps left in the legislation. Despite demonopolization, CSP is still dominant in compulsory insurance and the non-compulsory international, reinsurance, and export fields. Its ownership is now held by the Obchodni Banka (14 percent), Komercni Banka (7.6 percent), and Interbanka (7.6 percent). Investicni a Postovni Banka and Ceska Sporitelna are also shareholders. Ceska Sporitelna has also purchased 70 percent of Zivnostenska's insurance company, Zivnostenska Pojistovna.

The "Act on Supplemental Pension Insurance with State Contributions" (February 1994) allowed private pension plans and abolished the state monopoly on pension systems. According to regulations, a pension fund has to be established as a separate entity and have minimum capital of K 20 million (US$ 650,000). The law limits the amount to be paid to beneficiaries to 10 percent of assets. Investment abroad is restricted. Investment by pension funds is limited by law to GoC and bank bonds, Czech companies sold on the PSE, and Czech property. Investment in any one company cannot exceed 10 percent of the value of the total investment portfolio, and investment in any single security cannot exceed 20 percent of the value of that security. By September 1994, 48 applications were filed, and three private pension funds were established. The first private domestic pension fund was Penzijni Fond, established in October 1994 as a subsidiary of the state insurance company, Ceska Pojistovna. By early 1995, there were 41 pension plans which had received approval, of which 35 were operating. Among those which applied for a pension fund are Komercni, Investicni a Postovni, Ceska Sporitelna and Agrobanka. Funds operated by foreign insurance firms are also very active. The 1994 legislation allows for foreign participation of up to 49 percent. Winterthur (Switzerland) was the first foreign company to set up a private pension fund in November 1994. ING's (Netherlands) insurance wing, National-Nederlanden and Allianz (Germany), in a cooperation with Bayerische Hypotheken und Wechsel-Bank (Germany), both received licenses to establish pension funds in early 1995.

(continued...)

32
play an active role in developing the equities and bond markets. However, because of the significant cross-ownership that exists between the banks and a range of investment, insurance and pension funds, many analysts believe there is serious potential for conflict of interest that can weaken corporate governance. Reforms are needed to address (i) the absence of minority shareholder rights; (ii) the time-consuming process of settling share transactions; (iii) companies' inadequate disclosure of financial information; and (iv) insider trading, especially given that many of the biggest funds are owned by banks that lend money to companies whose shares are held by the Funds. In addition, the existing regulatory system (i) lacks adequate measures for reporting requirements; (ii) has poor transparency; (iii) suffers from weak enforcement by the Ministry of Finance; and (iv) fails to provide for an independent securities commission. The existence of two marketplaces—the stock exchange and the RM-System—results in a dispersal of liquidity and volume. Due to the large transactions taking place in the unofficial market, the turnover of the PSE is low. This, in turn, is caused by a non-standardized trading system which lacks standard dealing, settlement, and custodial arrangements, pre-empting large block trades to participate in determining the market price. Local accounting rules also strengthen the trend against trading. The accounting system forces traders to recognize a loss if they sell voucherized shares at a price below K 1,000 (US$ 30-35), the value arbitrarily assigned to first wave shares. To correct some of these weaknesses, the Czech Republic intends to amend the existing Securities Act by the end of 1995. The amendments to the Securities Law are expected to include plans to introduce a new trading system consistent with international standards. Specifically, the amendments are expected to (i) abolish over-the-counter (OTC) trading outside the two recognized markets (the PSE and the RM-System), which presently accounts for 80 percent of all trading; (ii) establish an independent regulatory body; (iii) impose stricter requirements for disclosure; (iv) remove the monopoly of the Securities Center in settling transactions; and (v) introduce measures to protect minority shareholders' rights. Additionally, in an effort to increase the transparency of transactions, a group of the largest brokerage houses in Prague have signed an agreement to report OTC trades voluntarily. The system is to be modelled on the US National Association of Securities Dealers' (NASD) rules, requiring brokers to report traded shares, including volume and price per share.

Hungary

Despite Hungary's openness, its state-owned banking sector has been unable to stimulate domestic investment in the economy on a sustainable basis. There are now 41 banks operating in Hungary. Half

77 (...continued)
Nationalne-Nederlanden operates a joint venture pension fund with EPIC (Austria) and a Czech employers' association.

73 The largest investment fund is operated by Ceska Sporitelna, the state savings bank, which manages around 500 shares of companies in its portfolio. Investicni a Postovni has a US$ 1.4 billion fund. Zivnostenska controls ZB Trust. Foreign banks such as Creditanstalt (Austria) and CSFB (Switzerland-US) operate investment funds. There are also funds located offshore that are focused on investment in the Czech Republic.

74 Average daily turnover was only US$ 13.6 million in June 1995.

75 This will oblige publicly-traded companies to release half-yearly results (in addition to yearly), reveal shareholders whose stakes exceed 5 percent, and disclose the remuneration of board members.

76 The monobank was split in 1987 into a central bank (NBH) and three commercial banks (Magyar Hitel Bank, Kereskedelmi Bank, Budapest Bank). In 1989, joint-venture banks and private entry were allowed, and by 1990, all banks were given the right to carry out universal banking activities. In 1991, the Banking Act was passed, which established the State Banking Supervisory Agency (SBS) and a bank regulatory framework.

33
of these banks are foreign-owned or joint-venture banks, and they are the most profitable and dominant in trade finance, bond issues and other fee-generating activities.\footnote{Hungary has allowed new private, joint-venture and wholly foreign-owned banks to establish themselves in the marketplace as openly and freely as any transition economy. Of Hungary's 41 banks, about three-quarters are private. Among the private banks, about one-third are domestically controlled, while two-thirds are joint ventures or foreign-controlled. Private banks account for about 25-30 percent of deposits, loans and total assets. Market share for joint-venture and foreign-owned banks approximates 15 percent, which understates their clear superiority in income due to trade financing, bond underwriting and other fee-generating activities.} The state-owned banking system dominates banking based on balance sheet measures (assets, loans, deposits),\footnote{State banks account for about two-thirds of assets, loans and deposits. The four largest state banks—OTP, MHB, K&H, and Budapest Bank—represent 55 percent, 54 percent and 60 percent of assets, loans and deposits, respectively.} but is troubled despite multiple recapitalizations. Net lending flows to the private sector have declined in recent years as the fiscal deficit has grown, and now account for less than 30 percent of bank lending (see Section IV). Financial intermediation rates are about 34 percent, higher than in Poland but lower than in the Czech and Slovak Republics. Much of this relates to macroeconomic imbalances (high inflation rates and fiscal deficits), prompting GoH to pay high real rates on government securities. This has attracted domestic banking system resources, diverting funds away from loans to the private sector (see Section IV).\footnote{The banking system is also now less willing to provide credit to loss-making state enterprises because tightened budget constraints are now being imposed, and with it the likelihood that no additional recapitalization of the state banks will occur.}

However, with a significant portion of the economy in the informal sector, most investment coming from smaller enterprises (partly fuelled by remittances from offshore), and high levels of foreign investment in larger enterprises, Hungary has been able to increase its investment in fixed assets since 1993 despite banking system weaknesses.\footnote{In fact, Hungary's level of domestic investment was highest in absolute terms as well as relative to GDP in 1994. However, with a fiscal deficit of nearly 8 percent and inflation rates of about 25 percent, such a trend is unsustainable without changes in economic policy.}

As for capital markets, Hungary has been more effective at developing its bond (debt) markets than its equities markets. Hungary's bond and Treasury bill market is capitalized at about US$ 5 billion, or nearly three times that of its equity markets (shares, investment units, compensation notes).\footnote{Money and capital markets reforms began in Hungary as early as 1983, when the government allowed the reintroduction of corporate bonds. Issued initially by municipalities, cooperatives, and financial institutions, these bonds were traded in a segmented market with separate rules for household and institutional investors. Issuing bonds specifically designated for households, which were fully guaranteed by the state and tax-exempt, required special permission from the Ministry of Finance. Secondary trade in bonds was allowed in 1984. In 1986, the government reduced restrictions on household investments. Until 1988, demand for bonds was high due to higher yields over bank deposits and the tax exemption. In 1988, bonds began to lose their appeal. In addition to abolishing the division of the market between institutional and individual investors, the government placed a 20 percent tax on interest and capital gains received by individuals and lifted the state guarantee. The rise in the inflation rate and the introduction of other instruments, such as CD's and Treasury bills in 1988, further diminished the demand for bonds. Recently, the tax break allowed for dividends was granted to government bonds, which increased the attractiveness of the latter. Investments in government bonds held for three years can now be offset against income tax for up to 30 percent of annual income, an exemption previously reserved for shares.}
government bond market dominates, largely due to the high fiscal deficits and debt payments that need to be made. A deterioration in Hungary’s macroeconomic fundamentals prompted a decline in Hungary’s international ratings in 1995, and for the interim, it is expected that the government bond market will be active. This has contributed to the diversion of investment resources away from the private sector, a trend that could continue until conditions are stabilized.

In 1990, GoH passed the Securities and Stock Exchange Law, which provided for the creation of the Budapest Stock Exchange. The Budapest Stock Exchange had 50 brokerage firms (including the central bank) with 33 shares listed in mid-1995. BSE capitalization is expected to increase with the privatization of blue chip infrastructure enterprises, and another 700 or so enterprises to be divested by AVPRt by 1997 (see Section III). However, taking mid-1995 stock market capitalization of US$ 1.4 billion into account, the equities market is only expected to approximate 3 percent of 1995 GDP, low by international standards. Part of the reason for low market capitalization is the lack of development of the institutional investment sector. Insurance and pension funds are yet to emerge as actors in the capital markets, though the state has deregulated both sectors. There are currently around 20 local investment

---

82 Corporate bond issues have been limited to private placements. In 1993, there was only one public issue of a corporate bond, and this was relatively small (HUF 160 million, or then US$1.6 million). There are no corporate bonds listed on the Budapest Stock Exchange. Bonds and commercial paper are offered through an underwriting and selling group, usually organized by one of the leading brokerage houses or commercial banks. Local subsidiaries of Levi Strauss, CSFB, and McDonald’s are among those which issued parent-guaranteed 4-year paper. The commercial paper market has also been dominated by multinationals, such as Unilever, Samsung Electronics, CSFB, and Nestle. However, these have also been small by global standards, totalling US$ 91 million. Two companies have issued "income bonds" that take advantage of tax exemptions that regular bonds do not feature. The one-year issues make fixed-rate distributions, classified as dividends, from after-tax profits and retained earnings and, unlike regular bond interest payments, incur no taxes for the investor.

83 While Hungary has a positive reputation for debt service in international capital markets, its ratings were downgraded in February 1995 to BB+ with a "Negative" outlook (from "Stable") at Standard and Poor’s. This has remained through September 1995. Hungary’s Ba1 rating at Moody’s has been constant in 1995 through September.

84 The law (i) set the regulatory framework for issuing and trading securities, public disclosure, insider trading, brokerage firms; and (ii) established the State Securities Supervisory Board, which oversees brokers, dealers, and the central depository and clearinghouse. Based on the Securities Act, the Budapest Exchange was opened on June 21, 1991 by 41 founding members, with 14 shares traded, and an initial market capitalization of HUF 29 billion (then about US$ 390 million). A central depository and clearing system (Keler), which is not a guarantor, was established in 1993. Regulated over-the-counter trading began in March 1995 for a limited number of shares on the BSE, including those of MOL (oil) and the three largest banks (OTP, Budapest Bank, MKB). Unregulated OTC trading is also available.

85 Only about 10 shares trade regularly. The distribution of securities on BSE in mid-1994 was: (i) 33 equities; (ii) 25 bonds; (iii) 17 Treasury bill issues; (iv) 17 investment units; and (v) one compensation note. Bonds and Treasury bill issues account for more than 70 percent of BSE capitalization. Foreign institutional investors account for 75 percent of all activity on the BSE, mostly in debt securities. Daily turnover approximates US$ 14 million.

86 Hungary was the first Visegrad country to reform its insurance system. The Reform Law of 1986 broke the State Insurance Company’s monopoly, allowed private entry, and divided the state monopoly into two along the lines of their specializations: Allami Biztosito (life, housing) and Hungaria Biztosito (non-life, international, motor).
funds which manage about US$ 170 million. Funds are limited to holding a maximum of 5 percent in any one security. Non-residents can hold up to 40 percent of a fund. Perhaps the most serious weakness of the Hungarian securities market is the increasing dominance of GoH debt securities, crowding out private sector investment. In 1990-1991, equities constituted 98 percent of turnover, whereas this ratio fell to 18 percent in 1992, 15 percent in 1993, and 30 percent in 1994.\(^7\) Many observers believe BSE will continue to be dominated by its government securities market until (i) debt and deficits are reduced; and (ii) the tax regime is simplified and more level in terms of incentives for investment in equities and debt.\(^8\) Eliminating these distortions is needed to increase market capitalization, promote private sector development, and specifically to accommodate the capital needs of many of the remaining 740 companies to be divested by GoH over the next three years.

Poland

Investment in Poland is partly constrained by financial sector weaknesses, both in the banking sector and in the capital markets. Financial intermediation rates, as measured by broad money (domestic currency component) to GDP, are 22 percent, the lowest among the Visegrad countries and well below averages found in developed, high-growth and middle-income countries. The banking system remains concentrated, with specialized state banks (BGZ, PKO BP, PKO SA, Bank Handlowy) and nine

\(^{86}\) (continued)
The two insurance companies were subsequently converted into joint-stock companies in preparation for their privatization. In 1990, Allianz (Germany) took a 49 percent share in Hungaria Biztosito. The first private company to enter the insurance market was Atlasz Insurance Company (with participation from the travel company Ibusz) in 1988. Today, there are more than 25 firms and 200 brokerages active in life, pensions, and the housing credit markets. Foreign companies have entered the market through joint ventures with local firms or branches. In addition to Allianz, other foreign firms include (i) Colonia’s (Germany) 12 percent investment in Atlasz in 1989; (ii) Generali’s (Italy) and Erste Allgemeine’s (Austria) joint ventures with Allami; (iii) American Insurance’s 59 percent stake in the private First Group American/Hungarian Insurance Company; and (iv) several Austrian and Swiss insurance companies. The Law on Voluntary Mutual Benefit Funds passed in late 1993 allowed for the creation of three types of funds: health, death/redundancy, and pension. Most of the funds created under this law are pension funds and are founded by companies. There are no minimum capital requirements, and contributors can enjoy a tax deduction of up to 30 percent of their annual incomes.

\(^{87}\) This has been due to the high financing needs of GoH. To provide incentives to investors to purchase GoH securities, the government provided two tax breaks: (i) up to 30 percent of income on GoH bonds held for more than three years; and (ii) 10 percent tax on GoH paper, as opposed to 10-20 percent taxes applied to equities.

\(^{88}\) Some progress has been made in this direction. Recent amendments to tax legislation included a measure to tax dividend income at 10 percent (as opposed to the previously variable rate of 10-20 percent), which should have the effect of equalizing the relative attractiveness of dividends and government securities. The Ministry of Finance has also proposed (i) abolishing the 10 percent withholding tax on dividends; and (ii) eliminating the 3-year holding period to qualify for tax relief on shares.

\(^{89}\) Poland began to reform its banking sector in 1989, when it dissolved the monobank system and created nine regional commercial banks. The Banking Law of 1989 set liberal regulations on entry to the sector, and the number of new private banks rose quickly to 75 in 1990 and 90 in 1992. (There were 73 banks in Poland in mid-1995). A few state banks have been partly privatized since 1993 (Export Development Bank, Wielkopolski Bank Kredytowy, Bank Slaski, Polski Bank Rozwoju, Bank Przemyslowo Handlowy). However, the largest national state banks (PKO BP, PKO SA, Bank Handlowy, BGZ) have remained state-owned. After several scandals and recognition of deep structural weaknesses in the banking system in 1992-1993, GoP revised the regulatory framework which raised capital levels, strengthened bank supervision, and provided for uniform deposit insurance.

36
regional commercial bank spin-offs from the central planning era controlling about 80-90 percent of banking system assets, loans and deposits. On a positive note, Poland has proceeded with at least partial privatization of three of the nine regional commercial banks and two smaller specialized banks, and restructuring is ongoing in advance of full market liberalization in 1999. On the negative side, BGZ (agricultural bank) in particular has run up significant losses in the troubled agricultural sector, and represents a costly dilemma to GoP due to its poor financial condition: both restructuring and liquidation would be expensive. This structural challenge is compounded by the solvency problems faced by PKO BP (housing bank). These two specialized banks account for about one-third of banking system assets on a book-valued basis, and therefore represent a major financial and operational restructuring challenge. Meanwhile, despite some privatization, organizational restructuring, and operational improvements, Poland’s regional commercial banks have still not demonstrated the capacity to deliver affordable world class banking services to Poland’s growing private sector. Net lending to the private sector has stagnated at about 30 percent of total bank lending (see Section IV). From a savings standpoint, about 25 percent of household and enterprise savings (about US$ 5 billion) are estimated to be held outside the banking system. The banking system is less willing to provide credit to enterprises due to high levels of non-performing loans (past and present). This reduces the amount of investment resources available to the enterprise sector, and partly accounts for low financial intermediation rates. Alternatively (as in Hungary), banks have chosen to invest in government securities to benefit from high net spreads between securities and deposits. Despite reforms and improvements, Polish banks are not competitive by EU standards. To protect the domestic banking sector, the central bank (NBP) set restrictions in 1992 on foreign entry to the sector, announcing that any foreign bank seeking a license should acquire an ailing Polish bank. As the Association Agreement with the EU requires the elimination of such barriers by 1999, it appears that the Polish banking sector will need to accelerate reforms if it is to be competitive once the market opens up. Meanwhile, Polish banks have played only a limited intermediation role in stimulating private sector investment.

Capital markets development is also limited. Capital markets reform began in 1989 when the Ministry of Finance issued inflation-indexed bonds convertible into shares of privatized companies. Since then, short-term bills and commercial paper have been introduced. The legal framework for capital markets was set in April 1991, when the Securities Law (i) established the Warsaw Stock Exchange (trading) and Securities and Exchange Commission (supervision); and (ii) set the regulations regarding financial institutions and investors. The law was designed to conform to EU standards. However, as expected during the early years in which markets emerge, there are significant institutional weaknesses which slow or deter investment. Equity markets are hindered by (i) the limited number of brokerage

---

90 Assets are on a book-valued basis. BGZ has serious loan portfolio weaknesses from exposure to the agricultural cooperative sector. PKO BP has portfolio weaknesses in the housing sector. Other banks have non-performing loans, with estimates ranging from 10-30 percent. Thus, if marked to market, it is conceivable that the banking sector would be less concentrated.

91 This estimate was made by the Central Statistical Office as of September 1994, and represented a 5.6 percent increase over 1993.

92 The NBP introduced the first short-term NBP bills in July 1990, which were purchased mainly by institutional investors. The first commercial paper program was developed by the Polish Development Bank in 1992 for Prochnik (clothing manufacturer), Tonsil (electronics) and Exbud (construction). These issues have been followed by additional issues introduced by Citibank (US), the Polish Development Bank, and ING (Netherlands), with rates as much as 7 percent below the lending rate and offered with less stringent security requirements than bonds. The commercial paper market has increased in value from US$ 1.5 million in 1992 to about US$ 150 million in 1994. Investors are generally domestic financial institutions, companies and individuals. Most issues are privately placed and not traded on the open market.
houses (although this is changing); (ii) weak WSE capacity to collect and transmit data; (iii) long SEC flotation and valuation processes, and (iv) the tax regime (double taxation, tax on market transactions). Development of a corporate debt market is hindered because (i) long-term (more than one year) corporate debt has collateral requirements, a 20 percent tax on yields (versus GoP paper, which is tax-free), and fixed rates (which discourage investors worried about inflation); and (ii) short-term corporate debt (less than one year) requires WSE listing, and is subject to a stamp tax.

The WSE was opened in July 1991, and market capitalization reached US$ 140 million. By mid-1995, 52 companies were listed, with market capitalization of about US$ 4 billion (30 times 1991 values, but only about 4 percent of GDP). Daily trading volume remains small by global standards at US$ 15-20 million. The role and market capitalization of the WSE is expected to increase with the addition of 514 firms via mass privatization through National Investment Fund (NIF) shares, which will begin trading in 1996 (see Section IV). An OTC market is also starting to develop, although this will take time. Even taking mid-1995 stock market capitalization of US$ 4.4 billion, the equities market is only expected to approximate 4 percent of 1995 GDP, low by international standards.

Greater investment is likely to come with more formal development of the financial sector. There is currently a limited number of institutional investors (insurance, pension funds, mutual funds) which

93 This can be corrected by (i) requiring the Securities Commission to answer companies' filings by a given deadline; (ii) providing an alternative fast track or self-registration for rights issues for those multinational companies whose prospectuses are widely circulated elsewhere; (iii) authorizing private placements for a wider range of offerings; and (iv) replacing the present minimum and fixed-pricing methods for the valuation of a share by underwriting and auction approaches.

94 There is no withholding tax on Polish government securities. Income from dividends from Polish companies and interest on loans are taxed at a fixed rate of 20 percent.

95 Foreigners are free to participate in the WSE, and non-residents are subject to the same levels of taxation as residents. However, foreign investor interest is much lower than in Hungary and the Czech Republic, and domestic small investors account for an estimated 80 percent of WSE activity.

96 The Council of Ministers approved OTC regulation on June 30, 1995, and became effective one month later. The only eligible traders on the OTC are brokers, although the market will be open to all on an "offer and bid" basis. The Securities Commission must approve all eligible securities, and all transactions are to be cleared with the National Depository of Securities.

97 Legislation on insurance passed in July 1990 lifting the state monopoly on insurance. The insurance market was opened to private entry, and the sector was subject to the supervision of the Ministry of Finance. By end 1991, the monopoly insurance company Powszechny Zaklad Ubezpieczen (PZU) was split into two companies (life, non-life). Each was converted into a joint-stock company owned by the Treasury. Apart from PZU, the market now has about 40 insurance companies. Investment by insurance companies is limited to "approved assets" (GoP securities, mortgage loans, non-agricultural real estate, shares of companies traded on WSE). Shares held in any one company cannot exceed 10 percent of the value the insurance company's funding. The value of an insurance fund's total investment cannot exceed 30 percent of its capital for listed shares and 15 percent for unlisted shares. Foreign companies can operate only through a joint-stock company (joint venture, wholly-owned, branches). Examples of joint ventures with local companies include (i) Assurances Generale de France's 49 percent joint-venture with Solidarity; (ii) American Insurance Group's 55 percent stake in two joint ventures with PKO; and (iii) Colonia's (Germany) ownership of the travel policies of Westa.
have emerged in Poland, including closed-end mutual funds whose entry has been deterred by restrictive legislation tying them exclusively to the mass privatization program in the form of National Investment Funds. Prior to mass privatization, there were only about 20-25 registered investment funds, many of which were inactive except for a few selected investments, often outside the exchange. However, with the introduction of mass privatization, high growth rates projected for the coming years, and investment grade ratings announced in June 1995 by international rating agencies, investment can be expected to increase. GoP commitment to accelerated privatization would further stimulate needed investment.

Slovak Republic

Because of the Slovak Republic's relative macroeconomic stability, the financial sector has done little to impede private sector development. The tax regime is relatively balanced, and certainly not out of line with its Visegrad competitors. While the government has increased its share of bank borrowings to finance its deficit (and subsidize SOEs), banks have increased their direct lending to private enterprises and away from state enterprises (see Section IV). Thus, net flows of credit have increased to the private sector, and financial intermediation rates are about 55 percent, which is higher than in Hungary and Poland. On the other hand, high levels of concentration in the banking sector and limited capital markets development have done little to advance the private sector. As in the Czech Republic, the banking sector is highly concentrated. While there are 29 banks, including eight foreign banks and 10 branches, the majority of the sector's assets are held by the former (partially privatized) state banks. Combined, these banks accounted for 68 percent of assets, 72 percent of loans and 93 percent of deposits at end 1993.

Capital markets emerged with the first wave of privatization during the CSFR period. Stock market capitalization was US$ 1.9 billion in June 1995 (about 14 percent of estimated 1995 GDP), a significant increase from end 1994 despite slow privatization. Bond market capitalization was about US$ 1.1 billion in September 1995, with maturities generally ranging from two-five years. Structural

98 The Social Security Act of 1991 was the first step to reforming the pension system. Currently, companies such as PZU and WARTA provide private pension plans that supplement the public pension system.

99 Agencies and ratings: (i) Standard and Poor's: BB with a "Positive" outlook; (ii) Moody's: Baa3; and (iii) IBCA: BB +.

100 This is indicated by the Slovak Republic's upgraded rating from Standard and Poor's in May 1995: from BB- with a "Stable" outlook to BB + with a "Stable" outlook. Moody's rated the Slovak Republic for the first time in May 1995 as a Baa3, which has not changed since.

101 According to the tax system introduced on January 1, 1993, income from shares are exempt from personal income tax. Withholding taxes of 25 percent apply to the profits of a "silent" (passive) partner. Dividends are taxed at 15 percent, capital gains at 40 percent, and interest on GoS bills and notes are tax exempt.

102 The three largest banks are (i) VUB, the former state industrial bank, with 30 percent of assets, 39 percent of loans and 34 percent of deposits; (ii) SSB, the former state savings bank, with 29 percent of assets, 19 percent of loans and 52 percent of deposits; and (iii) IRB, the former state investment bank, with 9 percent of assets, 14 percent of loans and 7 percent of deposits. As of mid-1994, (i) VUB was 48 percent owned by the National Property Fund and/or state; (ii) SSB was 100 percent owned by the NPF; and (iii) the IRB was 33 percent owned by the NPF/state. Most of the state banks were partially privatized through the first wave of voucher privatization, although these "privatized" banks have weak governance, dispersed shareholdings, and significant exposure to other "privatized" and large state enterprises that have yet to undergo needed restructuring.
weaknesses exist with regard to the equities market. However, the limited value and volume of activity (500 securities, of which only 13 are listed on the Bratislava Stock Exchange, along with eight GoS securities and four corporate bonds) is primarily due to political obstacles to privatization since the first wave ended in 1993.

The Bratislava Stock Exchange (BSE) was opened in April 1994 based on the Securities Act and the Stock Exchange Act (1992). This legislation also established a Securities Commission accountable to the Ministry of Finance. The Slovak Republic established the region’s first options exchange, the Bratislava Options Exchange (BOE). BOE also opened in April 1994, and trades in 80 stocks. Recent changes in legislation will (i) establish a new and autonomous regulatory body, the Office for the Supervision of Capital Markets (within the Ministry of Finance); (ii) ban unregulated OTC trading to increase transparency; (iii) require that all trades be recorded in the central registry and carried out through registered brokers; (iv) stiffen disclosure requirements, obliging traded companies to publish annual as well as semi-annual reports, and requiring investors whose shares in companies reach the 5-50 percent levels to disclose their purchases publicly; (v) raise minimum capital requirements for brokerages from SK 1 million (US$ 30,000) to SK 5 million (US$ 150,000); (vi) require the brokerage houses and the three exchanges to re-apply for licenses in the two months after the law takes effect; and (vii) ban one-day forward contracts, which make up 95 percent of BOE transactions, introducing in its place a new minimum of 15 days for forward contracts.

Risks to capital markets development have been raised by GoS efforts to limit the influence of IPFs (see Section III). The recently passed amendment (mid-1995) to the Act on Investment Funds prevents IPFs from exercising ownership rights in firms in which they hold equity, barring them from taking seats on company boards of directors. Currently, there are more than 160 IPFs active in the Slovak Republic, the major institutional investors in the market given the limited number of insurance companies and pension funds. Many experts believe efforts to limit IPF influence in the marketplace

---

103 As in the Czech Republic, the dispersal of trading among several exchanges creates illiquidity and intensifies the lack of transparency of the system. While the official market is divided into three markets, the off-market attracts as much as 90 percent of daily transactions. To draw some of this trading to the official and regulated markets, GoS recently introduced legislation to unite the three exchanges (BSE, RM-System, Bratislava Options Exchange) under the roof of the Bratislava Stock Exchange.

104 Trade turnover (equities, daily fixed deals on the options exchange, but not options and forwards) breakdown is as follows: (i) 72 percent on the options exchange (BOE); (ii) 22 percent on the RM-System; and (iii) 6 percent on the BSE. There is also an informal market where large blocks of shares are traded through Slovakia’s computerized securities clearing center connected to BSE, BOE, and the RM-system.

105 BSE has registered and listed securities, with prices fixed daily. As in the Czech Republic, there is an RM-System (created during the first wave of privatization) which operates OTC trading. The RM-System is a network of 150 offices across the country.

106 The amendment to the Law on Capital Markets was approved on July 13, 1995.

107 The de facto autonomy of the Office is uncertain as it is housed in the Ministry of Finance.

108 The levels are 5 percent, 10 percent, 20 percent, 30 percent, 40 percent, and 50 percent or more.

109 BOE will have two months to adapt to the rule. The amendment does not stipulate the previously proposed unification of the three exchanges, although the re-licensing requirement for the exchanges would leave that option open.
raise disturbing questions about (i) potential corporate governance problems in the enterprise sector; (ii) the growing politicization of the privatization process; and (iii) long-term capital markets development. Ultimately, many observers believe the Slovak Republic will need to (i) depoliticize economic policy to enhance confidence in and attract investment capital to the Slovak market; and (ii) accelerate privatization and restructuring of the enterprise sector in a transparent manner to expand the potential market for banks, bondholders and equity investors. Until then, investment and financial sector development might very well lag, which could undermine Slovak competitiveness just as it is time to integrate into the EU.

5. "Natural" Monopolies

An important precondition for successful privatization and demonopolization is establishing the appropriate regulatory framework. Designing such regulation is critical not only to ensure efficiency in the case of a natural monopoly, but also to create a predictable policy environment so that the private sector can be lured for investment. Greater clarity concerning EU policy and global trends toward privatization and multinational alliances should help define Visegrad responses in the coming years. In designing the regulatory framework, the consensus belief is that the Visegrad countries will need to ensure that (i) competition is feasible, by "vertical" or "horizontal" unbundling, so that potentially competitive activities are separated from those that require more regulation, and privatization of the company does not create market concentration; (ii) there is appropriate and detailed price/profit regulation to remove potential political interference; and (iii) regulatory institutions are independent from the political process.

In the Visegrad economies, many SOEs have operated with monopoly rights that are often left to the market in other countries (telecommunications, power generation and distribution, oil and gas, airlines). Demonopolization has been slowed in some sectors (utilities, infrastructure) by state perceptions of "strategic" assets, "national" value, and privatization difficulties. However, significant recourse exists to protect "strategic" or "national" interests without the costly exercise of public management and control. These include: (i) retaining a golden share, such as a seat on the Board or veto power over certain decisions; and (ii) introducing coupon/voucher methods of privatization for enterprises of national cultural value. In the case of industries that are not always easy to privatize (municipality-level public transportation, district heating, water and waste water, waste disposal), private participation through sub-contracting, employee buyouts, leaseholds and private concessions can improve performance and service delivery. It remains to be seen how quickly the Visegrad countries will move to privatize and

---

110 The guidance provided by EU policies is particularly relevant, but only in those areas where EU policy itself is clear. In telecommunications, the EU has a clearly defined policy which permits the southern European states until 2003 to introduce competition in basic telecommunications services. In response, Hungary has limited its grant of exclusive rights to MATAV, the partially privatized telecommunications company, to eight years, ending in 2002. Likewise, in the Czech Republic, the telecommunications monopoly of SPT (27 percent privatized in 1995) is to end at 2000. Airline regulation is being negotiated on an international scale (as is telecommunications), and should follow market developments that point to increasing globalization and privatization. In contrast, EU policies on gas and electricity are under debate among member states, and consequently much less clear. While EU policy debates continue, the privatization of public utilities and oil and gas is proceeding on an international scale.

111 The "golden share" approach works well as long as these rights are strictly limited. Undue interference in the governance and management of a company or excess use of veto power can also undermine company performance, and send negative signals to the market.

112 The Czech Republic has kept many breweries, porcelain and glass manufacturers in "national" hands (pension funds, health insurance funds, municipalities, IPFs, management groups) because of their value to traditional production and culture.
demonopolize in these areas. The Czech Republic has moved quickly in several sectors, and Hungary has already distinguished itself as one of the pioneers of private sector participation in several infrastructure and utilities activities. Although significant privatization remains to be accomplished, both countries have demonstrated their commitment to divesting state assets in most of these sectors. By contrast, Poland and the Slovak Republic have pursued a slower approach to demonopolization and privatization in many infrastructure and utility sectors. Box 4 summarizes degrees of demonopolization and private sector participation by country and sector.
### Box 4: Demonopolization and Privatization in Infrastructure and Utilities

| Box 4: Demonopolization and Privatization in Infrastructure and Utilities |
| --- | --- | --- | --- | --- |
| **Telecommunications** | **Czech** | **Hungary** | **Poland** | **Slovak** |
| Partial privatization of SPT; full demonopolization by 2000 | Partial privatization of MATAV; private entry common | TPSA remains state-owned; privatization may begin in 1997; demonopolization since 1994 | Slovak Telecom is state-owned; no plans for privatization; some demonopolization, private entry |
| **Electricity** | Partial privatization of CEZ; demonopolization of power distribution | Privatization of MVM in process; demonopolization of generation and distribution | Demonopolization and privatization of generation and distribution expected | SPP state-owned; taken off privatization list |
| **Oil** | Partial privatization of refining; petrochemicals may remain state-owned; distribution is demonopolized | Demonopolization of MOL oil; privatization in process | Partial demonopolization; private share is two-thirds of retail; 20% privatization of 3 refineries in process, with limits on foreign participation | Remonopolization of the oil refineries, petrochemicals sector and retail market with Slovnaft acquisition of Benzinol; partial privatization (20%) |
| **Gas** | Privatization and demonopolization of CPP in process | Privatization in process; partial demonopolization, but regional gas distributors dependent on MOL gas | Partial privatization is anticipated | SPP removed from privatization list |
| **Airlines** | Partial privatization of CSA | Partial "privatization" of MALEV to state-owned ALITALIA | Plans to partially privatize LOT; state to retain 51% | Tatra is one-third private; GoS open to private entry |
| **Ports** | Open to privatization of ports; plans to privatize MAHART (river transport) | Privatization of Szczecin port |  |
| **Railways** | GoC open to privatization of CSD | Passenger and freight open to private entry; MAV to restructure | PKP restructuring; partial privatization anticipated | Railway remains troubled by losses |
| **Roads** | Highway construction state-controlled for tariff protection; transport private | Demonopolization and partial privatization; HUNGAROCAMION to be fully privatized | Demonopolization and partial privatization; transport mostly private | Steady demonopolization and increasing privatization |
| **Water** | Municipalization of water services; private contracts let | Municipalization of water services; private entry in solid waste and water treatment | Some private participation in waste water services | Municipalization of services |

*Sources: Air Transport World; Business Central Europe; Business Eastern Europe; East European Business Law; East European Markets; Economist Intelligence Unit; Encyclopedia of Polish Industry 1995; Energy Economist; Financial Times; Oxford Analytica; Project and Trade Finance; "Hungary: Private Sector Assessment", World Bank, 1995; internal World Bank documents.*

**Czech Republic**

The Czech Republic has increased private sector participation in the telecommunications, electricity generation and distribution, gas distribution, and oil sectors due to recent privatization transactions (see Section III). The following represents a brief summary by sector:

- **Telecommunications**: SPT, the telecommunications monopoly, was 22 percent privatized (by voucher) in the second wave of mass privatization, followed by the June 1995 sale of 27 percent to a
Dutch-Swiss consortium. The company has a guaranteed monopoly over long distance and international telephone service until 2000, when competition will be introduced. Local telecommunications services, cable,\textsuperscript{113} or other value-added services do not enjoy this monopoly.\textsuperscript{114} Since many West European telecommunications companies are themselves state-owned, the Czech Republic passed a resolution in 1992 limiting investment by any state-owned company in the Czech telecommunications sector to 15 percent. The sale of a strategic share of SPT was formulated in August 1994, when GoC announced a general plan for the sector, including the establishment of a regulatory framework by the end of 1995. The proposed regulator will have the authority to set tariffs, which must be approved by the Ministry of Economy (long-distance services) or the Ministry of Finance (domestic services).

**Electricity:** The demonopolization of the electricity sector began in July 1990, when (i) the distribution and supply operations of CEZ (the national electricity monopoly) were transformed into eight independent regional distribution companies, while (ii) generation, transmission, and power system dispatching remained under CEZ control. CEZ was converted into a joint-stock company in May 1992, and 26 percent of its shares were privatized through the first wave of privatization. Another 4 percent was offered during the second wave, while 67 percent was retained by the National Property Fund (NPF) and 3 percent by restitution funds.\textsuperscript{115} The distribution companies were also converted into joint-stock companies in January 1994, and 15 percent of their shares were offered in the second wave of voucher privatization, leaving 27 percent to the NPF, 24 percent to municipalities, 20 percent for a strategic investor, and 4 percent to restitution funds. The privatization of electricity companies was based on the Act on the Conditions of Transfer of State Owned Property to Other Persons (1991). However, privatization was slowed down by the absence of a regulatory framework regarding pricing policy, environmental rules, and supervision. The first attempt at setting such a framework came in February 1992 with the passage of an energy policy statement requiring energy prices to be consistent with the requirements of the legislation on environmental protection. A more comprehensive Energy Act came into force in 1995, covering rules for private licenses. According to this Act, the Ministry of Industry and Trade is now responsible for submitting proposals for price regulation and granting licenses to companies entering energy generation and distribution. The minimum duration of a license is 25 years. In addition, the Act provides for a separate regulatory body, the National Energy Inspection Office (NEIO), subordinate to the Ministry of Trade and Industry, which is authorized to impose fines up to K 50 million (US$ 1.7 million). Successful privatization of the distribution and generation companies is likely to require a more detailed framework for price regulation.

**Gas:** Until the end of 1993, the gas sector was controlled by the Czech Gas Works (CPP). As with the electricity sector, the first step towards demonopolization and privatization was the unbundling of the company. In January 1994, CPP was broken up to form (i) eight regional gas distribution companies; (ii) five companies to take over the propane filling stations; (iii) several mechanical engineering plants; and (iv) Transgas, responsible for the transport, maintenance, storage, and importation of natural gas. The government passed a regulation opening the cable market to private entry in 1994. The NMT analogue network service is also open to private licensing, and Eurotel Praha has 49,000 subscriptions with 80 percent country coverage. While subject to competition, it is likely that SPT Telecom will continue to dominate the local services market.

\textsuperscript{113} The Czech Republic is the only country in the region to offer a genuine nationwide private TV network (Nova TV, which is majority-owned by CME of the US).

\textsuperscript{114} The government passed a regulation opening the cable market to private entry in 1994. The NMT analogue network service is also open to private licensing, and Eurotel Praha has 49,000 subscriptions with 80 percent country coverage. While subject to competition, it is likely that SPT Telecom will continue to dominate the local services market.

\textsuperscript{115} In mid-1994, CEZ accounted for about one-third of the market capitalization of the Prague Stock Exchange, or about US$ 4 billion.
of gas (mainly from Russia).\textsuperscript{116} The gas distribution companies are to be privatized based on the same scheme as applied to the electricity distribution companies, with 20 percent offered to strategic investors and the rest to the NPF, municipalities and restitution funds. The five propane companies are to be offered for direct sale. The mechanical engineering plants are to be sold separately. Gas prices and licenses are now governed by the Energy Act (effective January 1995). Transgas is to be retained by GoC for five years.\textsuperscript{117}

- **Oil:** The state sold 49 percent of its oil refinery industry to an international consortium (IOC) of Dutch Shell, Conoco (US) and Agip (Italy) for US$ 173 million plus a commitment for an additional US$ 500 million for needed construction and modernization of refinery equipment.\textsuperscript{118} Along with privatization, the import market is being opened up to competition with the construction of the Ingolstadt-Kralupy pipeline from Germany. While the IOC is interested in the refinery segments of the two companies, the petrochemicals segment may stay under state monopoly. On the other hand, the oil distribution sector has been opened to domestic and foreign oil distributors, and the retail market has been expanding. Like natural gas, indigenous oil supplies are limited, and have traditionally been imported from Russia.

- **Airlines:** CSA, the national airline, was "privatized" in 1992 when Air France (also state-owned) and the EBRD took a 38 percent stake for US$ 60 million. However, due to problems that later emerged between CSA and Air France,\textsuperscript{119} GoS bought the 19 percent share of the airline owned by Air France back for US$ 27 million, and announced its willingness to look for a domestic investor. Thus, CSA remains state-owned. Meanwhile, the Czech government opened the construction of a new terminal for Prague's Ryzyne airport to a tender, which was won by Bouygues (France) and British Aerospace. This will expand airport capacity from 1.8 million passengers to 4.8 million by 1997.

- **Ports:** Inland waterways accounted for 3.5 percent of total freight transport in 1994.

\textsuperscript{116} The primary source of energy in the Czech Republic is domestically produced coal, which supplies over one half of gross energy consumption. Nuclear energy is also important, accounting for one-fifth of electricity produced in 1993. The new Ingolstad-Kralupy pipeline from Germany is intended to reduce dependence on domestic coal and imported gas and oil from Russia. Two US corporations are also assisting with the Temelin nuclear power plant, the first reactor of which will start to operate in September 1996.

\textsuperscript{117} In early 1995, GoC considered and subsequently rejected the sale of a 25 percent stake in Transgas to Gazprom (Russia), Ruhrgas (Germany), Gaz de France (France), OVM (Austria) and SNAM (Italy).

\textsuperscript{118} Stakes in the biggest Czech refinery, Chemopetrol, as well as its smaller competitor, Kaucuk Krapuly, were sold to the consortium.

\textsuperscript{119} In March 1992, Air France and the EBRD each paid US$ 30 million for 19.1 percent shares of CSA, with GoC retaining 49 percent and the remaining 12.8 percent held by small shareholders (through the voucher scheme). At that time, both foreign investors accepted a valuation of CSA at around US$ 150 million. However, once the Czech government opened the sector to private competition, other foreign airlines quickly captured as much as three-quarters of flights in and out of Prague. While profitable in 1991, CSA had losses of US$ 7 million in 1992 and US$ 40 million in 1993. In the fall of 1993, a second valuation of the company revealed that the original valuation had overstated CSA revenues. As a result, Air France and EBRD demanded that GoC pay the amount they had overpaid for their 38.2 percent share, or that their stake be raised accordingly. In the end, GoC paid Air France US$ 27 million to buy back its 19.1 percent stake, while EBRD held on to its shares.
• **Railways:** The Czech government has stated its intention to open up CSD, the national railway, to at least partial privatization. Currently, 100 percent is held by the state. However, it is included as one of 70 entities for which interested investors could submit privatization proposals.\(^{120}\)

• **Road Construction, Transport and Haulage:** Initially, the Czech Republic considered opening highway construction to the private sector under build-operate-transfer (BOT) agreements. A tender was prepared with three consortia for the concession to build and operate a toll road from Pilsen to the German border. However, GoC subsequently cancelled the concessions because it felt the tolls to be charged would be excessive for Czech motorists. Consequently, GoC decided to finance highway projects from budgetary resources and international borrowings.

• **Water Supply and Treatment:** Water treatment and supply is now the responsibility of municipalities, which are increasingly looking to private sector participation.\(^{121}\)

**Hungary**

Initially, Hungary pursued a statist strategy which combined the absence of regulatory changes with slow or no infrastructure privatization. Major infrastructure enterprises were designated under the 1992 Law on the Management and Utilization of Entrepreneurial Assets Permanently Remaining in State Ownership. Accordingly, they were transferred to the State Property Agency and State Holding Company (except for the regional water companies, which were entrusted with the sector ministries), both of which were merged in June 1995. The 1992 Law specified minimum state ownership levels for these industries along with "golden share" protection in some cases. However, since 1992, significant progress has been made in regulating and privatizing activities in the telecommunications, electricity generation and distribution, and airline sectors, often with foreign participation.

• **Telecommunications:** Until 1990, MATAV had a monopoly over telecommunications. In 1990, the first concession for analogue cellular telephones was awarded to Westel,\(^{122}\) a joint-venture between MATAV and US West. In September 1993, 15-year concessions for digital cellular telephones were awarded to two competing firms, Westel and Panon-GSM (a multinational consortium). This was followed in December 1993 with the 30 percent sale of MATAV to Magyar Com (Deutsche Telekom and

---

\(^{120}\) In the spring of 1995, the Hamburg Port Authority bought a 25 percent stake in Metrans, a large rail transport company which owns the Czech Republic's largest rail container terminal.

\(^{121}\) In early 1994, a Finnish water treatment chemicals producer (Kemira) acquired 51 percent of a plant in Precheza (Prerov), which produces ferric chemicals for the purification of drinking and waste water. Through the joint-venture, a US$ 3.7 million investment to modernize the Precheza plant was planned. In addition, GoC has granted a contract to an American firm (Resource Conservation) to build a plant to clean up sulfuric acid waste at the Diamo uranium mine, 40 miles from Prague.

\(^{122}\) These were: (i) 25 percent plus one vote for HUNGAROCAMION (international road haulage) and regional gas companies; (ii) 50 percent plus one vote for MOL (oil), MVM (electricity), MAHART (water transport), MALEV (national airline), and regional water companies; and (iii) 100 percent for MAV (railway).

\(^{123}\) Westel, a joint venture between MATAV and US West, operates both analogue NMT and digital GSM networks. Its analogue system has 60,000 customers in Hungary's main cities.
In February 1994, regional telephone franchises were unbundled from MATAV and sold to private investors through the first tender to operate local telephone services in Central Europe. Fifteen of 54 telephone districts were won by foreign-led consortia. These exclusive concessions were granted for eight years, ending in 2002 (one year in advance of the EU 2003 deadline for phasing out exclusive concessions in telecommunications). Budapest and 38 districts were retained by the partially privatized MATAV. The second stage of MATAV privatization (the state still owns 60 percent) is being planned, and expected to reduce the state share to 25 percent plus 1 vote. The state has also awarded licenses in paging and satellite technology. The Telecommunications Act placed VSATs (very small aperture terminals) under the "competitive" industries group, opening it to entry. Nationwide FM sub-carrier paging was awarded to a joint venture with French partners, and in May 1994, two 15-year concessions were given to consortia with foreign partners. Progress introducing competition in the television sector has been slower. Due to resistance from the state television company, MTV, the proposal to sell one of the two national terrestrial channels was halted. However, the state will auction off the military channels.

Electricity: As with local telephone services, the state unbundled the electricity industry before privatizing segments of it. In 1992, the industry was reorganized into one national transmission company, eight generating companies, and six regional distribution companies. They were all put under the umbrella of MVM, a holding company. In 1993, the state attempted to sell shares in electricity distribution companies. However, due to uncertainties in the regulatory framework, bidding prices were too low (6-60 percent of the offer price), and the offer was withdrawn. It was not until the Electricity Act in April 1994 that privatization could proceed. The law settled regulatory uncertainties, outlined general pricing rules, and retained the vertical integration of the sector by leaving the companies under MVM. However, the law also stipulated competition in electricity generation by obliging the transmission company to buy from the lowest price generator. The generation sector was also opened to private entry. Currently, proposals to establish private independent power generation projects are being considered. The state has made plans to sell up to 100 percent shares (minus one golden share) in the four generation companies that rely on coal-fired plants (which require the greatest modernization and rehabilitation), and 75 percent shares in the three larger, non-nuclear companies. GoH has also raised electricity rates and intends further increases to more accurately reflect electricity costs, encourage conservation, and improve the financial condition of the various entities responsible for generation and distribution. Provided the state retains 100 percent of the nuclear power station and the transmission system as planned, these sales would divest 50 percent (minus one golden share) of the overall MVM company, as required by decree. MVM reported a loss of HUF 11.7 billion (about US$ 100 million) in 1994. Nevertheless, privatization is scheduled to be completed by the end of 1995.

Setting clear regulations has been an integral part of the success of the privatization of MATAV. Price increases in MATAV's services have been tied to the producer price index (PPI) after 1995. To retain a "golden share", the state has created a special "B" preferred share carrying special rights such as (i) representation on the Board; (ii) casting votes at general meetings; and (iii) having veto rights over changes in share capital and corporate mission, mergers/acquisitions, appointment of Board members, and acceptance of new international loans.

According to the law, the Ministry of Telecommunications could grant the region of a failed local service concessionaire to MATAV rather than being obliged to open it for tender.

MATAV retains the exclusive concession to domestic and international long-distance.

Electricity and gas prices were increased by 31 and 21 percent, respectively, in 1995. Most of the increases were passed on to households. Further tariff increases of 8 percent are were introduced in September 1995. Subsequent gas and electricity price increases of 18 and 25 percent, respectively, are expected in March 1996.
Gas: In the natural gas sector, Hungary’s strategy has also been to unbundle assets before privatization. MOL, the fully integrated oil and gas company, has 74 percent of the gas and heating market. Regional gas distributors are completely dependent on MOL, which is responsible for the exploration, production and transmission of natural gas. By decree in 1993, the state was required to retain 50 percent plus one vote in MOL. In mid-1994, the partial sale of MOL (up to 50 percent) began. In May-June 1994, 9 percent of MOL shares were transferred to municipalities, compensation voucher holders and individuals through a share issue. Since then, the state has approved plans to sell an additional 30 percent of MOL to two or three strategic investors, reducing the state share to 25 percent plus one vote. The state intends to ease control of prices, which are currently at about 50 percent of world levels, to improve MOL financial prospects and facilitate privatization.

Gas distribution is the responsibility of the five regional state-owned companies spun off from MOL’s predecessor in 1991[128] and the Budapest Gas Works’ distributor, Fogaz (owned by the municipality). GoH has announced plans to sell 100 percent (minus one golden share) in the five regional gas suppliers. In April 1994, a law to facilitate the sales of stakes in the regional gas distribution companies was passed, and resolved contested issues on regulation and pricing. Tenders for 50.1 percent of the five regional gas distribution companies operating outside Budapest are to be issued in 1996-1997. The sale of the sixth (owned by Budapest) will also proceed in 1996-1997. Foreign investors were invited to bid for concessions for the five areas. However, bids will be affected by difficulties associated with valuations due to (i) subsidized prices at which gas is downstreamed from MOL to the regional companies; and (ii) how high retail gas price levels will be permitted to go after import, production and distribution costs. There is significant public and industrial opposition to increased prices. At the same time, below-market pricing drains balance of payments, as significant quantities of energy are imported.[129] GoH increased domestic gas prices 8 percent in July 1995, and announced there would be additional price increases in 1996.

Oil: Hungary liberalized wholesale and retail oil markets in 1990, which has demonopolized many energy-related activities. Nevertheless, MOL, the fully integrated oil and gas company, has (i) 69 percent of the wholesale petrol and 38 percent of the retail petrol market; (ii) 74 percent of the gas and heating market; and (iii) 35 percent of the retail diesel market. Unlike the gas sector, GoH has permitted liberalized pricing in the oil sector. As such, oil prices are close to world market prices. This will make it easier to attract strategic investors to MOL. However, significant levels of fraud have been reported with liberalization (selling gasoil to diesel users to take advantage of price differentials,[130] diesel thefts from railway engines, unregistered firms selling diesel products without paying taxes).[131] Many investors believe GoH will have to reduce the incidence of fraud in the oil markets to increase confidence. There has been very slow progress in this direction.[132]

128 Degaz Rt, Ddgaz Rt, Egaz Rt, Kogaz Rt, and Tigaz Rt had combined registered capital of US$ 347 million at end 1994. Degaz Rt, which supplies the southeast, was the only profitable distributor in 1994.

129 Gas imports, currently about 50 percent of consumption, are expected to rise to 80 percent of consumption early next decade.

130 Gasoil subsidies have since been abolished, erasing the price differential.

131 Shell withdrew from the diesel market because it determined it could not compete with informal diesel distributors given the latter’s avoidance of VAT, duty and profit taxes.

132 As of September 1995, only six of 300 cases involving oil fraud had gone to trial.
• **Airlines:** In 1993, 35 percent of the national airline, MALEV, was sold to Alitalia-Simest (Italy) for US$ 77 million. An additional 5 percent was offered to employees. In 1994, a project to expand the Budapest (Ferihegy) airport was let to a Canadian consortium under a BOT agreement.

• **Ports:** The main waterways for inland transport in Hungary are the Danube and the Tisza rivers. The port network includes public ports, various landing stages for agricultural products and gravel, oil ports, and industrial and factory ports. Public ports are located in Gyor, Dunaujvaros, Baja, Szeged and Budapest, which alone accounts for some 40 percent of the port traffic. There is only one port on the Tisza stretch. MAHART, a state-owned company, owns and operates the public ports. In addition to the ports, MAHART owns and operates a fleet of 340 river vessels which need an estimated HUF 50 billion (US$ 350 million) for modernization. Preparations for MAHART privatization are already advanced. According to the 1992 Law on the Management and Utilization of Entrepreneurial Assets Permanently Remaining in State Ownership, MAHART was placed under AVRt control, and the government was required to retain 50 percent plus one vote of its shares. In 1994, the partial privatization of MAHART began. BOT concessions are likely to be used in the construction and operation of new ports. The first tender was for the concession to build and operate a new port in Gyor-Gonyu. Due to difficulties in establishing a satisfactory financing plan, the tender was cancelled, with a revised tender in preparation in early 1995. Proposals for private concessions to other ports are also under consideration.

• **Railways:** MAV, the national railway company, has been one of Hungary's poorest performing SOEs. Losses were HUF 40 billion (about US$ 35 million) in 1994, about 1 percent of GDP. However, tariff increases (and passenger service subsidies) in 1995 reduced operating losses, and profits are predicted for 1998. MAV has generally been a poor performer because (i) revenues per kilometer for passengers and cargo declined in real terms by 17 and 22 percent, respectively, from 1987-1994; and (ii) MAV's real wage costs increased 30 percent despite a 15 percent reduction in personnel during the same period. By decree, the state is to retain 100 percent of the company. While being a highly integrated company along functional lines, MAV has offered some opportunities for rehabilitation despite the decree. Components of the rail transport industry were slowly broken down and privatized. In 1992, the catering service offered by MAV was privatized, and maintenance and workshop units might also be privatized in the same way. A new Railway Act (1993) permits private railways, separating the ownership and management of tracks from the passenger and freight component. A proposal to grant concessions for construction of a freight rail by-pass for Budapest is under consideration. However, the consensus among project financiers is that MAV requires major restructuring, starting with a more commercial focus which reduces its dependence on GoH subsidies.

• **Road Construction, Transport and Haulage:** Road transport is dominated by two state-owned companies, HUNGAROCAMION (international road haulage) and VOLAN (domestic bus and haulage). Entry into the road transport market began in 1988, and by 1991, one-third of road tons per kilometer were carried by private operators. In preparation for privatization, the 29 companies belonging to VOLAN were transformed into 300 limited liability companies. While converted to a joint-stock company, 25 percent plus one vote of HUNGAROCAMION had to stay in state hands. In August 1994, bidding for HUNGAROCAMION began. Since then, GoH has adopted plans to sell 100 percent of the company. BOT concessions started with the 1991 passing of the Concession Law (Act No. 16). Two private toll motorways and toll bridge licenses were awarded under the BOT structure. A 45-kilometer motorway between Budapest and Austria is being constructed by private operators. The Law on Local

---

133 Total traffic on the Hungarian part of the Danube was 11.3 million tons in 1991, while that on Tisza was 1.5 million tons.

134 This is despite GoH providing more than twice the level of subsidy (as a percent of GDP) than the EU norm of 0.45 percent of GDP.
Self-Government permits municipalities to introduce private participation through concessions and joint ventures in urban transport and municipal roads, although little has been achieved to date.

- **Water Supply and Treatment:** Water, sewage, and solid waste were recently transferred to municipal governments. The Law on Local Self-Government permits municipalities to introduce private participation through concessions and joint ventures. The Law on Water Concessions stipulates that only operational rights are transferrable under such arrangements, and for up to 35 years. So far, private participation has been introduced in solid waste and water treatment. Leaseholds and concessions were used for water and sewerage services in Karosvar and Szeged, and are under consideration for Debrecen and other areas.

**Poland**

Poland has made slow progress in demonopolizing and introducing incentives for private sector participation in most utilities and infrastructure. Initial partial privatization intentions have been announced in most sectors (telecommunications, oil and gas, airlines, water treatment), and private contractors are being sought for major motorway and pipeline construction projects. Road transport and construction is also largely private. Ports have also been opened to privatization. However, the pace of privatization and demonopolization has been slowed in key sectors because of political disagreements. The coal sector, which provides 84 percent of Poland’s power generation, has experienced only limited privatization. There is strong political pressure to cross-subsidize loss-making coal mines and guarantee employment for miners from restructured and liquidated mines. Recent parliamentary maneuvers also threaten to further delay demonopolization and private participation in the oil and gas sector, as well as other non-utility/infrastructure sectors (see Section III).

- **Telecommunications:** Unlike other Visegrad countries, Poland has so far postponed the privatization of its telecommunications company, TPSA, which is still 100 percent state-owned. In 1995, the Prime Minister announced that TPSA’s privatization would begin within two years. While privatization has been slow, TPSA’s monopoly ended in 1994 as the state awarded Sprint (US) a license to provide digital telecommunications networks in the Pila and Silesia regions. Sixty smaller local licenses were also awarded to others on a revenue-sharing basis. In August 1995, a tender for two additional licenses for digital cellular phone networks was announced. The introduction of digital networks will improve on the current cellular system, which uses an analogue system. TV franchising to foreign channels is also allowed. However, an amended Telecommunications Act (originally adopted in December 1994) appears to reinforce TPSA’s near monopoly position in the market. Unlike the Czech Republic and Hungary, Poland has not even announced privatization plans and international tenders for TPSA. Delays are expected due to parliamentary control of privatization plans in the telecommunications sector.

- **Electricity:** In mid-1992, new restructuring objectives for the Polish power grid system were established, prompting efforts to introduce competition among power generation companies and reduce the natural monopoly held by power transmission and distribution companies. Thus, a framework was

---

135 District heating and urban public transport were also recently transferred to municipal governments.

136 The only cellular operator in Poland as of August 1995 was Centertel SA. Centertel, with a network of more than 60,000 customers and 54 percent country coverage, uses an analogue system which is only operative with stationary phones. The digital network more fully links Poland’s telecommunications infrastructure to the Global System for Mobile Communication. Centertel is 24 percent owned by Ameritech (US). The company entered the mobile market in 1991, when its US$ 75 million bid won the tender for laying down a national cellular network covering 50 percent of Poland, using analogue technology. At that time, the more modern GSM technology was not open to concessions due to the military’s monopoly.
established for privatization, foreign investment, access to the transmission network, and cost transparency. By late 1994, the Polish Power Grid Company (responsible for the electricity sector) invited bids for new and modernized capacity from private investors as well as SOEs. Under the draft Energy Law adopted in August 1995, the electricity sector will be regulated by an independent energy regulation office. This office will control and approve pricing in the electricity sector, allowing "reasonable profits" to investors while protecting consumer interests. Thus, it is envisioned that electrical generation and distribution could be privately owned, but pricing, safety and service delivery will be regulated by a public agency. In early 1995, the Ministry of Trade and Industry announced plans to privatize 49 percent of the generating capacity of the state electricity company. However, to date, there have been no announced privatizations in the electricity sector.

- **Gas:** In September 1995, GoP adopted a restructuring program for PGNG, the Polish Oil and Gas Company which is a state-owned, joint-stock company responsible for the oil and gas sector. This is expected to involve the creation of the Polish Oil Company and the Polish Gas Company, which will be joint-stock companies with partial state ownership. PGNG will be responsible for the implementation of energy policy, creation and supervision of strategic gas reserves, management and coordination of both companies. Foreign participation is expected in the two sector companies, which points to partial privatization in this sector. Under the draft Energy Law adopted in August 1995, the gas sector is to be regulated by an independent energy regulation office. As with electricity prices, this office will control and approve pricing in the gas sector. In recent years, pricing has favored industry over households.

- **Oil:** GoP announced plans to restructure and partially privatize the oil sector, creating the Polish Oil Company (see "Gas" above). Unlike the gas sector, pricing is to be market-determined. Under the EU Association Agreement, concessionary restrictions in refining have to be phased out by 1997. Some progress has been made, as refineries have been able to import directly. However, progress remains piecemeal. According to proposals announced in early 1995, only 20 percent of the three refineries will be privatized, with the remaining shares to be owned by the Polish Oil Company (PKN). One-third of the refineries as well as the distribution network, pipeline and railway distribution system will be retained by PKN. There are limits of 30 percent placed on the amount of foreign investment to be permitted in refineries. In the retail market, competition has been introduced. While CPN retains significant market share (about 35 percent), other retail stations are privately owned. However, fuel price liberalization is being postponed until 1996. As with other infrastructure sectors, many observers expect delays in the demonopolization and privatization of the oil sector.

- **Airlines:** GoP announced plans in April 1995 to partially privatize LOT, the national airline. According to plans, the state would retain 51 percent ownership, while 29 percent would go to strategic investors and 20 percent to employees. An international tender was originally expected to be let in November 1995. This has been temporarily delayed as tendering criteria are being refined.

- **Ports:** While the operation of ports is now open to private entry, a foreign company needs to obtain a permit from the Ministry of Privatization to operate a sea port. The Szczecin shipyard, the country's largest, was restructured and privatized in 1991. It is now one of Europe's fastest growing builders of medium-sized container ships. A recent project worth US$ 60 million financed by a consortium of domestic and foreign banks will build two bulk carriers for a Norwegian company at the Gdansk shipyard, Poland's other large shipyard.

- **Railways:** The Polish State Railway, PKP, is a state-owned enterprise responsible for rail lines, rolling stock, and passenger and freight services. PKP generally relies on domestic industries to produce 1,400 of 4,000 retail petrol stations are owned by CPN. This excludes the approximately 5,000 fuel outlets off main roads and highways that are run by agricultural cooperatives and other groups which had fuel stations for internal use and are now selling to the public.
its rolling stock, although it has its own design, research and production capacity. PKP has been burdened for years with operating losses, which understate real losses due to insufficient depreciation, repair and maintenance of fixed assets. However, a restructuring program is expected to (i) privatize some of the assets and operations (commercial freight, international passenger services, some componentry production); (ii) spin off other operations (suburban passenger services) to local agencies with contracts with local and national authorities; and (iii) bring the railway sector in line with EU directives.

- Road Construction, Transport and Haulage: A BOT project in road infrastructure has been approved to build 2,571 kilometers of road network at a cost of US$ 7-8 billion, with each section awarded to a single license holder who is to bear 85 percent of costs. The construction will last 15 years, and the exclusive right 25-30 years. A toll road concession law to allow an east-west motorway costing US$ 2 billion was also passed in 1994. It is expected that highways will support themselves through user fees (tolls, transit fares, license payments), although construction costs will be financed from GoP sources and international borrowings. Much of the construction is expected to be performed by consortia of state and private construction firms, private investors, and banks.

- Water Supply and Treatment: GoP has agreed in principle to granting BOTs for water and sewerage projects. The Local Self Government Act (1990) transferred responsibility for water supply and treatment services to municipal governments. Some municipalities have have commercialized their water and waste-water enterprises and begun full cost-recovery pricing for services rendered. In 1993, Gdansk and Lodz municipalities allowed private sector companies to operate waste water services through projects financed by the EBRD. In Bielsko Biala, enterprises have been given joint-stock and limited liability status. In Gdansk, the SAUR-local government contract constitutes a private joint venture.

Slovak Republic

Slovakia has been the most conservative among the Visegrad countries in demonopolizing its utilities and infrastructure. In September 1993, the NPF still owned all or most of 517 state companies. Among the largest of them were Slovnaft (oil, 80 percent), Benzinol (oil distribution, 97 percent), and Nafta (gas, 55.2 percent). As in the Czech Republic, many of the larger and more "complex" privatizations were left to the second wave of privatization. While the Czech Republic has finalized the second wave and moved on to larger privatizations in the utilities and infrastructure sectors, the Slovak Republic has brought privatization in this sphere to a virtual halt since 1993 (see Section III). Infrastructure and utilities are still generally state monopolies, although GoS has stated its openness to private foreign investment in these sectors. The inability to attract foreign investment is one of the major reasons why demonopolization and privatization have lagged since 1993 (see “C4. Investment and the

---

138 These include (i) Pafawag Wroclaw and HCP Poznan for electric locomotives and passenger coaches; (ii) Konstal Chorzow for tramcars and specialist freight wagons; (iii) Zastal Zielona Gora for freight wagons and bogies; (iv) Swidnica for tank wagons; and (v) Fablok Chrzanow for diesel locomotives and brake apparatus.

139 Posted losses were OZ 2 trillion (then US$ 100 million) in 1993 after subsidies of nearly OZ 6 trillion (about US$ 300 million).

140 Utilizing the BOT method, foreign investors such as Asea Brown Boveri have entered the railway engine production industry.

141 The Toll Highways Act of 1994 regulates the procedure for private sector participation in the construction and management of highways. The Act provides for a bid system where the selections are made by the Ministry of Transport, and sets the minimum initial capital of a participating bidder at ECU 10 million (US$ 13 million).
Financial Sector" and "E. Foreign Investment"), although some progress has been made in the telecommunications sector. The new Act on Privatization and Priorities (1995) lists 45 state firms and joint-stock companies as "strategically important", and gives the state veto power over decisions in these companies. A further 25 companies (including railways, utilities, telecommunications, energy) are excluded from privatization.

- **Telecommunications:** Slovak PTT was split into Slovak Telecom and two postal companies effective January 1, 1993. According to legislation passed in June 1995, Slovak Telecom will become an independent state-owned company in January 1996. The same law has ruled out its privatization, and the company remains 100 percent state-owned. According to pending legislation which should come into force in July 1996, the company's monopoly over basic voice services will terminate in 2003. Other segments of the sector have already been liberalized. New private entry was allowed in terminal equipment market, mobile phone and value-added services, based on the 1992 Federal Telecommunications Law. A joint-venture between Slovak Telecom, Bell Atlantic (US) and US West (Eurotel Bratislava) already operates in the mobile phone sector, which has an analogue NMT network with 11,500 customers and 47 percent country coverage. A tender for two GSM digital cellular mobile licenses will be opened in November 1995, and is expected to be awarded by May 1996. Thus, while retaining state ownership of Slovak Telecom, GoS appears to be moving in the same general direction as Hungary and the Czech Republic. This is consistent with its EU Association Agreement, despite (for now) state control.

- **Electricity:** Slovensky Energeticky Podnik (SPP), the power (gas and electricity) company, was originally assigned to the second wave of privatization. However, SPP was subsequently declared "strategic" and removed from the list. It currently remains state-owned (through NPF).

- **Gas:** The gas utility (SPP) was removed from the privatization list once declared "strategic" in early 1995. Almost all of the gas that flows from the CIS to Central and Western Europe passes through Slovakia. This produced US$ 500 million in fees in 1994.

- **Oil:** Aside from VSZ Kosice (steel), Slovnaft (oil refining and petrochemicals) is the biggest exporter in the Slovak Republic. Slovnaft has been partly privatized through voucher privatization (20 percent) and share offerings in the capital markets (20 percent). However, more recently, the National Property Fund sold a 39 percent stake in the company to 19 senior Slovnaft managers at below-market values. According to many investors, the Slovnaft management buyout (i) raises questions about the terms of the transaction; (ii) threatens to undo the 20 percent acquisition of shares made earlier in the year in the capital markets, particularly as GoS and NPF did not disclose plans for a management buyout in the share offering prospectus; and (iii) undermines the Slovak Republic's integrity with regard to privatization and future investment, particularly as management buyouts have been used at the expense of competitive tenders for the Slovak Republic's most valued enterprises. Slovnaft has engaged in talks with Shell for its refinery activities. However, the state intends to control its petrochemicals operation, and GoS has been instrumental in remonopolizing the sector under Slovnaft's control. Subsequently, in March 1995, Slovnaft bought Benzinol (its domestic competitor), effectively returning its monopoly

---

142 Slovnaft planned a US$ 100 million international offering, due on December 8, 1994, but this was postponed because of political uncertainties related to its "strategic" status. Slovnaft finally launched its 3.3 million share offering for US$ 112 million (in the form of GDRs) in mid-1995, representing a 20 percent capital increase. The market response from investors was poor, and EBRD rescued the offering by purchasing US$ 59 million for a 10.5 percent stake in the company.

143 The state decided in March 1995 to accept Slovnaft's bid for the 51 percent stake at SK 1.3 billion (US$ 40 million) against 15 rival bidders. Among the bidders were OMV (Austria), Kuwait Petroleum, Royal Dutch Shell, Conoco (US), and Agip (Italy).
The sale of Benzinol to Slovnaft was referred to the Anti-Monopoly Commission, but was not overturned. The NPF defended its decision to sell Benzinol to Slovnaft based on global industry trends towards concentration of production and distribution. As a result, Slovnaft now has 80-90 percent of the retail market as well as a monopoly over oil refineries and petrochemicals. There were some indications from the state that it wanted to offer the remaining shares of Benzinol to a foreign investor. However, according to analysts, the 39 percent management buyout of Slovnaft combined with the earlier poor investor response to Slovnaft’s share offering makes this unlikely to occur any time soon. 

- **Airlines:** When CSFR split, the Slovak Republic owned part of Czechoslovak Airlines (CSA). GoS still has ownership in CSA. The Slovak airline sector is now open to private entry. Tatra Air was founded as a joint venture between Slovair and Crossair (a subsidiary of Swissair) in 1993. In March 1992, Crossair sold its one-third share to Cargo Rachbauer, an Austrian freight firm.

- **Ports:** Slovakia’s main port is the Danube River Port in Bratislava. The port of Komarno, a much smaller port, is located 90 kilometers downstream from Bratislava. Since the late 1980s, waterway traffic has fallen steadily due to the drainage of water resulting from dam construction. Waterway traffic reached a level of 1 million tons in 1993, which accounted for less than 1 percent of total freight transport that year. Main cargoes transported through the river are bulk commodities such as steel products, chemicals, and petroleum. The Slovak Danube Navigation Company (SPD) dominates the shipping sector with 300 vessels, of which a mere quarter to one-third are being used. SPD also operates four hydrofoils for passenger transport between Bratislava, Vienna and Budapest.

- **Railways:** The railway system remains state-owned and troubled. Due to the collapse of trade with the COMECON countries, which provided the majority of demand for Slovak railway freight, railway transport fell 60 percent from 1989 to 1992. In 1993, the railways (and road maintenance) received nearly US$ 1 billion in operating and investment subsidies, about 14 percent of total subsidies for the year. In early 1994, 35 percent of total inter-urban passenger traffic and 60 percent of freight traffic was carried by rail. Road traffic made up only 30 percent of total freight, while water traffic accounted for another 10 percent. Thus, the national railway system retains a significant role in commerce and trade, but represents a significant cost to the budget.

- **Road Construction, Transport and Haulage:** Until 1990, all construction was state-owned, including infrastructure-related construction. Privatization began in 1990, and by 1993 most construction companies were in private sector hands. There are still some large state-owned construction enterprises, and these dominate the major infrastructure project market (road construction and operations). The 17 largest construction companies in 1994 employed more than 35,000 workers, which accounted for one-fifth of the total construction labor force. However, privatization in this sector has continued. In 1993, 51 percent of construction output was produced by private companies.

- **Water Supply and Treatment:** Piped water supply coverage is 77 percent in Slovakia, relatively high. However, there is a need for extending existing capacity to under-served regions of the country by utilizing the unused capacity of regional systems. On the other hand, sewage systems need investment both to increase capacity as well as to upgrade efficiency. There is increasing understanding that the sector cannot depend on the national budget to finance future investments. GoS has decided to transfer the responsibility of water supply and sewerage services and ownership of facilities from the five state-

---

144 In 1992, Benzinol was hived off from Slovnaft (oil refinery, petrochemical, and retailing company) to create a separate retail company. Benzinol took 200 outlets (60 percent of total), and Slovnaft retained its monopoly over oil refining and petrochemicals. Domestic investors acquired 20 percent of Slovnaft's shares through the first voucher privatization. Yet, the state's indecision as to which industries to liberalize and the uncertainty over (and eventually, the cancellation of) the second wave led to a delay of further sales of Slovnaft's shares. The planned US$100 million international offering due in December 1994 was thus postponed.
owned regional companies to the municipalities by September 1995. The municipalities will also be responsible for setting tariffs, which previously were set by GoS at a uniform rate throughout the country. Municipalities will be free to contract out private sector enterprises for various services.

D. Taxation

Most observers believe Visegrad taxation is characterized by (i) high rates; (ii) excess complexity (exemptions, differing rates); and (iii) weak tax administration. These weaknesses result in (i) widespread tax avoidance; (ii) reduced investment in the formal private sector; (iii) distorted investment decisions based on short-term tax-induced incentives; and (iv) persistent fiscal revenue shortfalls. Aside from personal income tax rates, Visegrad rates are generally as high as those found in EU countries. Considering that EU tax rates are high when compared with the US, Japan, and most high-growth economies, this weakens Visegrad competitiveness. Insufficiently strong tax administration and reduced collections reinforce a vicious cycle of higher rates to try to make up for the shortfall. In terms of employment, Visegrad country enterprises often have little incentive to hire people permanently due to high social insurance costs. This contributes to the large number of owner-operated businesses which are often semi-permanent sub-contractors. In general, the Visegrad countries place a significant tax burden on the enterprise sector, largely for social insurance purposes. This could undermine long-term savings, investment and competitiveness unless rates are reduced (as has recently occurred in the Czech Republic and Hungary), loopholes are closed, and the tax base is broadened. The use of tax holidays (and associated administrative apparatus and procedures to agree and monitor), as actively followed by Hungary, Poland and the Slovak Republic, appears not to have succeeded in attracting investment.

| Table 3: Tax Revenue Contributions in the Visegrad Countries (1993-1994)* |
|-------------------------|----------------|----------------|----------------|
|                         | Czech          | Hungary        | Poland         | Slovak         |
| Value-Added Tax**       | 27.6%          | 20.3%          | 24.0%          | 21.1%          |
| Personal Income Tax     | 17.4%          | 18.1%          | 16.1%          | 11.1%          |
| Corporate Income Tax    | 26.7%          | 5.5%           | 8.4%           | 16.9%          |
| Social Security         | 25.6%          | 32.3%          | 44.2%          | 33.0%          |
| Trade                   | NA             | 8.7%           | 5.9%           | 3.5%           |
| Excise**                | NA             | 10.2%          | see VAT        | 15.0%          |
| Other                   | 2.7%           | 0.0%           | 1.4%           | 2.8%           |
| Tax Revenues/GDP        | 44.2%          | 39.3%          | 42.1%          | 38.6%          |

* Figures are 1993 for Czech Republic, Poland and Slovak Republic, 1994 for Hungary; ** VAT in Poland includes excise tax contribution to revenue.

Box 5: Tax Rates in Visegrad and EU Countries

<table>
<thead>
<tr>
<th></th>
<th>Czech</th>
<th>Hungary</th>
<th>Poland</th>
<th>Slovak</th>
<th>Selected EU*</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Value-Added</strong></td>
<td>0% (exports); 5% (food, fuel, oil, minerals); 23% for most items</td>
<td>6% or 25%</td>
<td>22% for most items; 0%-7% for some</td>
<td>25% for most items; 6% (food, energy, medicines, paper products)</td>
<td>7%-20.5%</td>
</tr>
<tr>
<td><strong>Personal Income</strong></td>
<td>15%-41%</td>
<td>25%, 35% or 40%</td>
<td>21%, 33% or 45%</td>
<td>15%, 16%-34%, or 47%</td>
<td>0%-60%; 20%-55% on average</td>
</tr>
<tr>
<td><strong>Corporate Income</strong></td>
<td>39%</td>
<td>18%-23%</td>
<td>40%</td>
<td>45%</td>
<td>33%-50%; 35%-40% on average</td>
</tr>
<tr>
<td><strong>Interest Income</strong></td>
<td>Not available</td>
<td>Not available</td>
<td>21%-45%</td>
<td>15%</td>
<td>0%-40%; 15%-30% on average</td>
</tr>
<tr>
<td><strong>Dividends</strong></td>
<td>Not available</td>
<td>10%-20%</td>
<td>21%-45%</td>
<td>25%</td>
<td>13%-45%; 20%-25% on average</td>
</tr>
<tr>
<td><strong>Social Insurance</strong></td>
<td>20%-50% payroll tax (44% from employer). 6.5% (5% employer) tax for unemployment fund.</td>
<td>54% payroll tax, Labor Fund taxes of 3% contribute to an unemployment benefits fund.</td>
<td>45% payroll tax, Labor Fund taxes of 3% contribute to an unemployment benefits fund.</td>
<td>50% payroll tax (employers contribute 38%, employees 12%).</td>
<td>2%-37%, with a wide range across countries</td>
</tr>
</tbody>
</table>

* Selected EU countries: Belgium, Germany, Greece, Netherlands, Spain, UK.


Czech Republic

The Czech Republic has high tax rates, as exemplified by a 42 per cent personal income tax rate in the highest range, a 39 per cent corporate tax, a 23 per cent Value-Added Tax (VAT), and up to 50 percent rates for social insurance. Overall, Czech tax revenues are about 44 percent of GDP. Accelerated privatization has contributed to total revenues (53 percent of GDP), and permitted GoC to "downstream" some public expenditure (public utilities, social infrastructure) to municipalities without disrupting fiscal stability. The Czechs have adopted a uniform policy of offering no tax holidays or benefits to investors, domestic or foreign, which separates the Czech Republic from the other Visegrad countries. While such uniformity reduces complexity and facilitates tax administration, high tax rates induce large-scale tax avoidance (although better than in the other Visegrad countries). Overall, the enterprise sector contributes an estimated 55 percent of total fiscal revenue, about par with Poland and the Slovak Republic and higher than Hungary. At the enterprise level, partnerships are not taxed at the entity level (corporate tax rate plus tax on dividends). Therefore, partnerships do enjoy a tax advantage

---

145 About 90 percent of total fiscal revenue is generated by taxes (direct and indirect), and about 10 percent of fiscal revenue comes from other sources. The distribution of contributions to tax revenues has changed since 1989, when income taxes contributed 53 percent of tax revenue, payroll taxes an additional 32 percent, and indirect taxes only 15 percent. In 1993, income taxes contributed only 25 percent of tax revenue, while health and social security contributions covered 28 percent of fiscal revenue and indirect taxes (value-added and excise taxes) added another 26.5 percent of total. Non-tax revenue has remained at about 10-12 percent of fiscal revenues from 1989-1993.

146 The Czech informal sector is estimated to constitute 12 percent of GDP, less than its Visegrad counterparts but still high compared to the 4-6 percent rates associated with most OECD countries.
over joint-stock and limited liability companies. Along with easier registration procedures, partnerships and sole proprietorships probably account for the bulk of self-employed and small-scale companies that have formed in the Czech Republic since 1990.

Hungary

Successive tax reforms have been introduced in Hungary in recent years due to increasingly severe fiscal deficits, rising stocks of public debt, and mounting insecurity regarding social insurance. Despite its most recent reforms (corporate tax rates), Hungary’s tax system remains burdened by high tax rates, particularly social insurance charges that are higher than in most countries of the world. Hungary’s VAT remains a high 13-25 percent. Personal income is taxed as high as 44 percent. High tax rates lead to high levels of non-compliance, a build-up of tax arrears \(^1\) (and budgetary pressures), and steady growth of the informal sector. This is particularly true for social insurance, where employers have been consistently responsible for 50 percent payroll contributions. \(^2\) Overall, tax revenues were about 39 percent of 1994 GDP (down from 43 percent in 1993), but well below expenditure needs. Tax revenues to GDP were on par with the Slovak Republic, and lower than in the Czech Republic and Poland. However, for Hungary, this is negative because of high levels of public expenditure and the highest fiscal deficit among Visegrad countries. In 1993, Hungary was second only to Slovenia among former socialist countries on a per capita revenue contribution basis. The willingness of Hungary’s tax payers to contribute has diminished, partly due to high tax rates. Because rates are so high, numerous exemptions or reductions are still provided, \(^3\) which adds to complexity, makes tax administration more difficult, and sometimes distorts investment decisions. As with Poland and the Slovak Republic, Hungary initially offered automatic tax holidays to encourage foreign investment, but withdrew most of them by 1994 to establish a more even system. \(^4\) GoH introduced further changes to its tax legislation at the end of 1993.

---

\(^1\) These arrears are largely in the state sector, which also provides them with an advantage over private enterprises.

\(^2\) In 1994, social security contributions (including unemployment compensation and wage guarantees) were 32 percent of total fiscal revenues. Employers were responsible for three-quarters of social security contributions, which amounted to 24 percent of total tax revenue.

\(^3\) For instance, personal income is taxed progressively from 20-44 percent. Exempted from personal income taxes are non-wage cash benefits, income from intellectual activities, rental income, alimony income, and income from small-scale farming.

\(^4\) The Tax Act of 1993 passed on November 23, 1993, and effective on January 1, 1994, abolished tax incentives offered to foreigners in an attempt to eliminate discrimination against domestic firms. In place of the previous exemptions, the new law introduced two new types of incentives geared to large-scale investors, regardless of origin of ownership. The previous system allowed firms with at least 30 percent foreign ownership and HUF 50 million (US$ 350,000) in capital to qualify for either (i) 100 percent tax exemption during the first five years, and 60 percent the next five years if at least half of revenues came from activities cited as "important" in the Company Tax Act; or (ii) 60 percent exemption during the first five years and 40 percent the next five years if at least half of revenues came from manufacturing. Beginning January 1, 1994, firms which had not made their investment prior to that date lost the right to qualify for the previous exemptions. The new incentives were different not only in terms of ownership (domestic and foreign, rather than just foreign investors), but also in that they were subject to Ministry of Finance discretion (rather than automatic). A company could now apply for a case-by-case exemption of up to 100 percent for the first five years and 60 percent the next five years, if it satisfied one of two conditions: (i) have at least HUF 500 million in capital, invest at least HUF 200 million, derive half of its revenues from manufacturing "environmentally friendly" products and/or the sale of products using modern technology and/or (continued...)
of 1994. As a result of these regulations, the tax burden for firms enjoying tax holidays rose. Hungary has reduced some tax rates in recent years (corporate and personal income tax rates) to broaden the base, and simplified other processes (VAT). However, the overall tax burden in Hungary remains high, reducing the incentive for companies to properly report transactions or hire additional permanent staff. The enterprise sector contributes about 43 percent of total fiscal revenue (low by Visegrad standards), with the balance about evenly divided between individual contributions and non-tax revenues. Most analysts believe the vicious cycle of high tax rates and pervasive tax evasion are unsustainable on a long-term basis. Ultimately, Hungary will have to contain public expenditure and achieve macroeconomic balance to provide the necessary environment for its private sector to be competitive and successfully integrate into the EU.

Poland

As elsewhere in the Visegrad countries, tax rates are high in Poland. Personal income tax rates are as high as 45 percent, corporate tax rates are a uniform 40 percent, and most consumption is taxed at 22 percent through a Value-Added Tax (VAT). Registered businesses are also required to pay 45 scientific research, and create jobs or increase exports through investment; or (ii) have at least HUF 100 million in share capital, and reinvest profits of at least HUF 25 million in a given year (subject to a penalty, once granted the exemption, if capital was reduced within five years). Off-shore incentives could also be offered by the Ministry of Finance if a company satisfied a series of stringent rules. These conditions included: (i) the company had to be in the business of trade or services (excluding financial) to third countries; (ii) a majority of its managing staff and personnel had to be Hungarian; (iii) the company had to be represented by Hungarian lawyers and audited by Hungarian residents; and (iv) all operating bank accounts had to be kept in Hungary. The law also allowed for a tax credit for interest paid on loans taken to purchase or construct fixed assets, and introduced a minimum tax (2 percent of defined revenues), obliging companies to pay taxes even during loss-making years. The minimum tax was criticized in particular because it discriminated against those companies that manufactured their own goods. Companies that qualified for the exemptions were exempt from the minimum tax in the same proportions.

Tax changes abolished the minimum tax, and replaced the previous 36 percent single corporate income tax with a dual stage rate that taxed declared profits at the basic rate of 18 percent (if after-tax profits were allocated to special profit reserves rather than distributed), and the distributed profits at a supplementary rate of 23 percent. The previous reinvestment incentive and two conditional large-scale investment incentives were withdrawn. Those that qualified for exemptions before could continue to benefit from such reductions, but only at the 18 percent rate, and not on the supplementary rate.

In particular, those that were previously granted exemptions and came from countries that have a dividend exemption system face higher taxes than before. On the other hand, for those firms from countries that grant an exemption for foreign source dividends, the overall burden could decline from 36 to 22 percent.

In 1994, corporate tax rates, previously 40-50 percent, were brought down to 18 percent on corporate income retained in the business and 23 percent on distributed income. Individual income tax rates were reduced from 20 to 60 percent to 0, 25, 35 or 40 percent in 1993. However, rates then went up to 20-44 percent in 1994.

In 1993, the VAT was changed from a three-tiered system (0, 15 and 25 percent) to a two-tiered system (6 and 25 percent). In 1994, the lower-tier of VAT increased from 6 to 13 percent.

In October 1995, Parliament approved a six-step personal income tax scale for 1996, at 19 percent, 21 percent, 24 percent, 31 percent, 38 percent, and 45 percent.

151(…continued)
percent of payroll taxes to contribute to pension funds, 3 percent of payroll taxes for unemployment compensation schemes, and 0.5 percent for guaranteed benefits. (All three social insurance charges are deductible from corporate income taxes.) Poland’s tax revenues approximate 42.5 percent of GDP, about average for the Visegrad countries. Many businesses believe Poland’s tax system is more complex than needed because ministerial decrees are frequently revised, particularly regarding tax exemptions for specific groups of taxpayers. The most striking feature in Poland (as in Hungary) is the high level of tax avoidance, driven largely by high tax rates, the high volume of cash and barter transactions, and some would say a general mistrust of government. This complicates tax administration, largely the responsibility of Tax Offices at the local levels. Tax Offices are tax tribunals which administer tax accounts in their jurisdictions. They are empowered to assess tax liabilities on firms if the Office believes taxable income has not been properly presented. This creates friction with the business community, and contributes to a cycle of distorted accounting and information flows. Current evidence suggests about 50 percent of fiscal revenues are derived from the enterprise sector, with most of the balance from personal income and individual VAT contributions. This structure shows companies carry a heavy tax burden, particularly in light of required payments for social insurance. The onerous tax burden undoubtedly contributes to tax evasion, as indicated by the size of the informal sector in Poland which accounts for about 20-25 percent of GDP (see Section IV). It is unlikely that high tax rates or high levels of tax evasion will be sustainable on a long-term basis if Poland is to successfully integrate into the European Union.

**Slovak Republic**

As in the other Visegrad countries, tax rates are high in the Slovak Republic. The VAT is a high 25 percent on most items, with a lower rate of 6 percent for food, medicine and a few other products. Personal income is taxed as high as 47 percent, and the corporate income tax is a high and uniform 45 percent. Employers are also responsible for about three-quarters of social insurance contributions, which is lower than Hungary and Poland but still high for employers at 38 percent. The Slovak Republic adopted the proposed changes in the tax law planned for Czechoslovakia in January 1993. Tax reform replaced the earlier reliance on turnover taxes assessed against SOEs to a VAT, personal income and corporate profit taxes. Payroll taxes from the earlier period were replaced with employer/employee contributions to four Social Insurance Funds (pension, health, sickness and employment). Overall tax revenues approximate 39 percent of GDP, low for the Visegrad countries. As the Slovak Republic has strengthened its fiscal position since 1993, lower revenue contribution rates are viewed favorably. However, other problems remain. While the Slovak tax code has not appeared overly complex for the enterprise sector, tax administration has been problematic. This has resulted in tax avoidance and a fairly strong underground economy, albeit less prominent than that found in Hungary or Poland. In particular, the application of taxes even when suppliers have not received payment (which leads to under-reporting and increased use of barter) has been an issue with exporters and foreign investors. The enterprise sector contributes about 50-55 percent of total fiscal revenues.

**E. Foreign Investment**

The Visegrad countries show mixed performance regarding the attraction of foreign investment. Hungary and the Czech Republic have succeeded in attracting foreign investment, including significant

---

156 Key tax exemptions chiefly concern exemptions from VAT: (i) businesses with revenues of less than OZ 800 million (about US$ 32,000); (ii) products in the meat, fish and poultry industries; and (iii) services provided for the postal, housing, education, culture, arts, health care, sports, agriculture, and research and development sectors.

157 The informal economy is estimated to be 15 percent of GDP in the Slovak Republic.
foreign direct investment which tends to be more permanent than inward portfolio investment from foreign sources. The Czech Republic has done so without special tax holidays or incentives, and succeeded due to its rapid privatization program. Hungary has succeeded with an open trade and investment regime plus tax holidays, and despite a gradualist approach to privatization (see Section III). By contrast, Poland and the Slovak Republic have fared poorly in attracting foreign investment, although foreign investment in Poland is beginning to increase. The consensus appears to be that poor performance in attracting foreign investment has much to do with (i) slow privatization; (ii) inadequate information; (iii) barriers to entry for foreign firms in selected activities; and (iv) comparatively frequent political turnover.

Czech Republic

The Czech Republic offers a relatively stable environment to foreign investors. Under the Commercial Code, foreign and domestic firms are treated equally. Tax incentives for foreigners were lifted after January 1993, when a uniform corporate tax rate of 45 per cent was introduced (now 39 percent).\textsuperscript{158} The only available tax holiday is a five-year tax exemption that applies to certain energy producers. Foreigners are not permitted to acquire real property directly, but can do so by leasing or establishing Czech legal entities. Unincorporated individual foreigners cannot own property (Foreign Exchange Law) unless by inheritance, marriage, a swap or "special act". However, a 100 percent foreign-owned company can purchase immovable fixed assets, including property. Foreigners can invest freely without limits on the size of holdings, sphere of economic/investment activity, and profit repatriation. Special approvals are not required from the government.

Foreign investors have responded favorably to the open environment despite high tax rates. Most FDI flowed into the Czech Republic during the first wave of privatization, in which 180 foreign firms made commitments exceeding US$ 5 billion covering 900 large Czech companies and 100,000 small ones. About half of these commitments materialized.\textsuperscript{159} Portfolio investment through the Prague Stock Exchange (largely from external sources) accounts for nearly three-quarters of volume (although not trades), and is by far the largest market in terms of capitalization among the four Visegrad countries at US$ 12.6 billion (end 1994). In general, the Czech Republic has generated very good performance since 1992, reflecting an open environment, the perception of attractive market opportunities, and increasing purchasing power. FDI of more than US$ 3 billion flowed into the Czech Republic from 1991-1994 (2.5 percent of GDP).

Hungary

The 1988 Foreign Investment Act, with some modifications made since, guides foreign investment in Hungary. Foreign investors can own 100 percent of the investment, including property (except agricultural land). If property is expropriated, investors are assured of full compensation in the original currency in which the investment was made. Full repatriation of profits is allowed, as are hard currency accounts at local banks. Tax holidays have been used to provide investors with incentives to invest. These included: (i) 100 percent holidays from corporate taxes during the first five years; and (ii) 40

\textsuperscript{158} The Ministry of Finance retains discretion for granting tax exemptions, but the Czech Republic's reputation has been one of uniformity in its tax treatment of domestic and foreign investors.

\textsuperscript{159} FDI in 1992-1994 was US$ 2.5 billion.
percent holidays from the corporate tax in the second five years if founding capital exceeds HUF 50 million (US$ 350,000), and foreign capital exceeds 30 percent of founding capital. Customs exemptions have also been used as incentives to foreign investors for (i) imports of capital equipment if this is part of founding capital; or (ii) if the equipment is paid out of hard currency accounts held in Hungarian banks. Since 1994, more level incentives have been provided to the investment community as a whole (see "D. Taxation"). Hungary is a member of the International Convention for the Settlement of Investment Disputes.

In general, Hungary has fared better than virtually all other transition countries in attracting foreign investment. On a per capita basis, Hungary attracted an average US$ 160 per year from 1991-1994, far in excess of such high-growth economies as Chile and Thailand. The cumulative total of 1991-1994 FDI was US$ 6.6 billion, accounting for about one-quarter of total investment in Hungary and equivalent to 4-5 percent of GDP during the period. Hungary has been successful in attracting FDI because of a competitive and open environment for trade and investment which has provided sufficient protection and returns to justify the risk. Despite macroeconomic weaknesses, many observers believe inward portfolio investment from abroad has been high because of Hungary’s comfortable levels of reserves and reputation for meeting international debt obligations. Strategic investment in blue chip infrastructure companies being privatized under the new Privatization Law (see Section III) is expected to increase FDI further in the coming years.

Poland

Foreign investment has been slow to develop in Poland. Under the 1991 Foreign Investment Law, foreign investors can establish joint-stock or limited liability companies. GoP approvals are required for (i) some joint ventures; (ii) participation in public enterprises when ownership changes to diversify operations; and (iii) when purchases of public land are made. Unrestricted investment exists only with private Polish enterprises which do not own or lease property. To encourage foreign investment, the Ministry of Finance can grant tax holidays, although these are no longer automatic. These include incentives to companies (i) with foreign capital of ECU 2 million (US$ 2.5 million); (ii) which operate in high unemployment regions; (iii) which operate in high-tech sectors; or (iv) which export more than 20 per cent of production. Tax credits are also provided up to the amount of foreign capital, and unrestricted profit repatriation is in effect as long as the company is not liquidated during the

---

160 This customs relief is provided unless the firm sells/leases the equipment within three years.

161 These include: (i) management arrangements at airports and seaports; (ii) real estate; (iii) defense sector transactions; and (iv) legal services.

162 In 1993, 539 applications were made by foreigners to purchase land, of which 126 were refused. Most refusals related to individuals’ applications to purchase agricultural land. Only 17 companies (nine of which were German) were refused. The process for a foreigner to receive a permit to purchase land or a perpetual usufruct (long lease) can take up to two months.

163 As in the Czech Republic and Hungary, automatic tax incentives previously offered to foreign companies were withdrawn in 1994. Eligibility for such incentives is now subject to the discretion of the Ministry of Finance. The present incentives cover only joint ventures, and the requirements are more stringent than before. To apply, (i) firms must have at least ECU 2 million (US$ 2.5 million) in capital; (ii) share capital cannot be reduced for two years; and (iii) more than 20 percent of products need to be exported.
period in which tax incentives were granted or two years afterwards. However, these incentives have generally been unsuccessful in enticing foreign investment.

Poland’s performance in attracting foreign investment has been weak despite having the largest economy among the Visegrad countries. With a GDP exceeding twice that of Hungary and the Czech Republic, cumulative 1991-1994 FDI amounted to only US$ 1.8 billion, less than a third of Hungary’s and only about two-thirds of the Czech Republic’s. Apart from food processing and beverages, tobacco processing and the automotive sector, Poland has attracted limited foreign investment on anything but a small-scale basis. However, commitments of US$ 5.1 billion were on record as of end 1994, and there is evidence based on investment-grade international credit ratings (Moody’s) and oversubscribed Eurobond issues (June 1995) that FDI is now increasing.

Slovak Republic

In 1992-1994, the Slovak Republic had cumulative FDI approximating US$ 340 million, a poor total when compared to Hungary and the Czech Republic. In 1993-1994, the Slovak Republic attracted only US$ 240 million, behind such countries as Ecuador, Thailand and Tunisia (on a per capita income basis) which have lower per capita incomes. More recently, trends have been even less favorable, with 21 foreign companies leaving in the first quarter 1995 and 165 others in the process (mid-1995).

Despite tax holidays, credit guarantees and subsidies, and exemptions from import duties, the consensus opinion is that efforts to attract foreign investment have been hindered by (i) lack of reliable information for establishing a business; (ii) bureaucratic delays related to approval and set-up; (iii) uncertainties regarding the second wave of privatization, particularly worrisome after two successive administrations have meddled with privatization transactions ex post facto; (iv) currency convertibility restrictions; and (v) lack of an effective Commercial Code for contract enforcement and dispute resolution (see "B3. Commercial Codes and Contract Enforcement"). This appears to demonstrate that tax incentives have little effect on foreign investment decisions. Unlike the other Visegrad countries, the Slovak Republic has chosen not to withdraw the initial tax relief it offered to foreigners. However, as

---

164 The Polish Agency for Foreign Investment claims foreign investment has been more than US$ 4.3 billion. However, these values include non-cash investments. Balance of payments figures indicate FDI to be less than half that amount.

165 The Polish Agency for Foreign Investment claims foreign investment in Poland reached US$ 1 billion by June, 1995. This was followed by GoP announcement in August (and agreement in October) that Daewoo would invest US$ 1.1 billion in the troubled car-maker, FSO, for a 60 percent stake.

166 To conduct business in the Slovak Republic, a foreign company needs to apply for a filing in the Companies Register at the Court of Registry. Registration requires the following documents: (i) business name and registered address; (ii) formation agreement; (iii) confirmation that declared founding capital has been deposited in a Slovak bank; (iv) trade license or other necessary legal agreement to trade; (v) description of business activities; and (vi) statement of the type of new company to be registered. The process usually takes around 4 weeks. Foreigners who wish to found a new company can do so via joint venture with Slovak partners or as a wholly foreign-owned business.
in other Visegrad countries, tax exemptions are not automatic but made on a case-by-case basis. Most investment has been small-scale in the service sector in/around Bratislava.  

Companies registered after December 31, 1992 which are at least 30 percent foreign-owned (or have at least DM 1 million, or US$ 600,000, in foreign-owned capital), are eligible to apply for a 100 percent corporate tax exemption in their first year, and a 30 percent reduction in the second and third years.  

At the end of 1992, US$230 million had been investment in Slovakia by foreign investors. Most investments were small (US$ 3,500-35,000), and in the service sector. The biggest investors were: Austria (US$ 63 million), Germany (US$ 57 million), and the US (US$ 44 million). Major companies include K-Mart (US), Volkswagen (Germany), Henkel (Austria), Molnlycke (Sweden), Samsung (Korea), Hoechst (Germany), and Whirlpool (Italy).
III. COMPARATIVE ASSESSMENT OF PRIVATIZATION

A. Introduction

Even with a favorable enabling environment, the real effect of an appropriate framework is demonstrated by the magnitude of privatization and the general impact on private sector growth. While Section II pointed to real progress in the enabling environment of the Visegrad countries, there are clearly weaknesses that persist and constrain private sector growth. Privatization, as a function of overall private sector development, has proceeded in different patterns and paces in the Visegrad countries. This section analyzes the comparative results of privatization in the enterprise sector after briefly discussing general goals, approaches, and conditions for effectiveness.

B. Methods of Enterprise Privatization Used by the Visegrad Countries

1. Summary of Privatization Methods and Objectives

Privatization worldwide has generally involved three goals which have not always been compatible: (i) to remove SOEs and state-owned commercial banks (SOCBs) from state ownership, primarily for purposes of systemic transformation; (ii) to generate the maximum level of proceeds from privatization sales, essentially to enhance fiscal revenue/cash; and (iii) to spread share ownership broadly through society, intended for (re)distributive justice. To achieve these goals, the Visegrad countries have used a mix of auctions, direct sales, mass privatization and liquidation. Asset stripping has also occurred in a number of countries, representing spontaneous privatization. Box 6 summarizes privatization objectives and methods by firm size in the Visegrad countries to date.

<table>
<thead>
<tr>
<th>Type of Enterprise</th>
<th>Objective:</th>
<th>Transparency</th>
<th>Value</th>
<th>Speed &amp; Distribution</th>
<th>Speed</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Preferred Method:</td>
<td>Auction</td>
<td>Direct Sales</td>
<td>Mass Privatization</td>
<td>Liquidation &amp; Asset Stripping</td>
</tr>
<tr>
<td>Large-Scale</td>
<td>None</td>
<td>Czech, Hungary, Poland, Slovak (after first wave)</td>
<td>Czech, Slovak (first wave)</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>Medium-Scale</td>
<td>None</td>
<td>Hungary, Poland</td>
<td>Czech, Poland, Slovak (first wave)</td>
<td>Hungary, Poland</td>
<td></td>
</tr>
<tr>
<td>Small-Scale</td>
<td>All</td>
<td>None</td>
<td>Czech, Slovak (first wave)</td>
<td>Hungary, Poland</td>
<td></td>
</tr>
</tbody>
</table>


Auctions have been used in all four countries to privatize small-scale enterprises. This method has been used to broaden distribution of SOEs in a transparent manner. Direct sales have been used in all countries to generate sales proceeds, and have usually involved the largest SOEs. Mass privatization has been used most successfully in the Czech Republic, where about 80 percent of assets are now in
private hands. The Slovak Republic also used mass privatization through 1993 (the first wave), but discontinued the process after that. Poland recently launched its long delayed mass privatization program, involving more than 500 enterprises (about 10 percent of total SOEs and 12 percent of remaining state assets). Liquidation and asset stripping have also been common, especially in Hungary and Poland. In Hungary, banks have frequently filed claims to liquidate enterprises failing to repay and service debts. Asset stripping has frequently occurred, reflecting weaknesses in the legal framework that have undermined the effectiveness of bankruptcy and liquidation procedures (see Section II). In Poland, asset stripping is part of the legal sale or transfer of assets of a state enterprise following formal bankruptcy, and is a formal part of the privatization process. Privatization via liquidation procedures accounts for more than one-third of privatization transactions to date in Poland. Some additional methods have been used with a mix of objectives, or different objectives. Management and employee buyouts (often on deferred payment bases through lease arrangements) have been utilized in all countries, and often represent "direct sales" or de facto liquidations, with speed or cronyism as an objective (rather than value). On limited occasions, direct sales have occurred through stock exchanges, combining value and transparency as an objective.

Restructuring has also been encouraged through "commercialization" or "corporatization" (conversion to joint-stock companies) and liquidations. Restructuring often occurs in advance of privatization, although limited restructuring (financial) is far more common than wholesale restructuring (financial, physical and operational). In some of the Visegrad countries, transfers of state properties to municipalities are sometimes included as "privatization" transactions because they relieve the central government budget of fiscal responsibility.

2. Country Reviews of Privatization Laws and Methodologies

Czech Republic

The Czech Republic/CSFR has been the greatest practitioner of rapid and mass privatization among the Visegrad countries. The Czech Republic passed two laws regarding privatization: (i) "small privatization" (December 1990), which applied to more than 22,000 "units" (shops, restaurants, other small enterprises) sold by local authorities through public auctions; and (ii) "large privatization" (June 1991), which applied to more than 3,000 larger enterprises resulting in more than 6,700 "project approvals" through direct sales, auctions, voucher privatization and restitution. By end 1994, (i) small-scale privatization, restitution, and transformation of cooperatives was fully completed; and (ii) large-scale privatization was about two-thirds complete. With National Property Fund transfers and completion of the "second wave" of mass privatization by March 1995, large-scale privatization was about 80 percent complete on an asset basis. Since that date, additional large-scale privatizations in the oil and gas and telecommunications sectors have added to that total (see "C. General Results of Enterprise Privatization in the Visegrad Countries").

Privatization methodology has been driven by considerations of speed, fairness, and capital constraints (limited savings and purchasing power of the populace), with particular emphasis on speed. This has clearly differentiated the Czech Republic from the other three Visegrad countries in their approaches to privatization. Laws and government decrees began in October 1990 with six components to "denationalize" about K 1,500 billion (US$ 50 billion) in assets: (i) restitution of expropriated property to former owners (US$ 3 billion); (ii) transfer of state property to municipalities, mainly infrastructure, heating and local utilities (more than US$ 12 billion); (iii) transformation of cooperatives (US$ 8 billion); (iv) small business auctions (US$ 0.7 billion); (v) sales, restitution and transfer of large SOEs (US$ 13 billion).
billion); and (vi) share transfers to citizens via vouchers (US$ 12 billion). Thus, the Czech Republic
(originally CSFR) focused on privatizing SOEs quickly, and spreading share ownership broadly and
quickly through society. Generating maximum proceeds from privatization sales was partly subordinated
as a goal (compared to Hungary), although this remains an important part of the GoC's privatization
strategy, having (i) sold more than US$ 2 billion in more than 3,350 direct sale transactions; and (ii)
retained ownership in nearly 200 joint-stock companies via the National Property Fund, with plans to sell
most stakes to (foreign) investors who are in a position to pay higher prices. While enterprises are
considered privatized once they are transformed into joint-stock companies and assigned to the National
Property Fund for privatization (about 84 percent of NPF transactions), the NPF has generally acted
promptly. Among the four Visegrad countries, the Czech Republic has achieved the greatest degree of
success in removing the burden of costly SOEs and SOCBs, generating privatization proceeds and
foreign investment, and spreading share ownership broadly through society.

Hungary

Hungary has pursued a gradualist and multi-faceted approach to privatization, privatizing about
half of state assets from 1989-1994. In 1989, Hungary had 1,832-2200 large state enterprises and
about 10,000 smaller enterprises, all valued by GoH at about HUF 2,000 billion (then US$ 30
billion). By mid-1995, 924 larger enterprises had been at least partly privatized (more than 620 fully),
and 536 had been liquidated. These 1,460 privatization transactions involved about US$ 10 billion in
assets and generated about US$ 3.5 billion in proceeds. Based on remaining shareholdings, the state has
HUF 1,500 billion (US$ 10.5 billion) in equity in 740 enterprises (minority and majority holdings), about
80 percent of which is to be divested in the coming years. Most transactions have been via open tender.

The Czech National Property Fund had handled K 896 billion (US$ 30 billion) in asset disposition by end
1994. These consisted of (i) K 748 billion in "contributions to the property of joint-stock companies"; and (ii) K
148 billion in direct sales (K 71 billion), transfers (K 45 billion), public tenders (K 26 billion), and auctions (K 7
billion). Of the contributions to joint-stock companies, voucher privatization (K 349 billion, or US$ 12 billion)
during the first and second waves represented the most widely used method. Another K 146 billion (US$ 5 billion)
were disposed of by transfers, direct sales, offerings on the capital markets, and restitution. An additional K 194
billion (US$ 7 billion) is being retained by the NPF at least temporarily.

This position is stated with caution. The Czech Republic still confronts numerous structural weaknesses
regarding the risk of cross-ownership of banks, Investment Privatization Funds, and enterprises. It remains to be
seen if the government will bail out large, insolvent enterprises and/or banks in the future. If so, this contradicts
relieving the state of the costly burden of supporting loss-making banks and enterprises. However, to date, the
Czech Republic has achieved this goal despite the absence of widespread bankruptcies.

The range of figures is offered because several large SOEs are actually holding companies which have large
companies that operate as subsidiaries. For example, seven of Hungary's largest strategic enterprises (MATAV,
MVM, MOL, ANTENNA Hungaria, the power distribution company, power generation company, and gas
distribution company) actually comprise 24 enterprises or companies. Thus, Hungary more likely started with about
2,200 large SOEs.

More than 9,600 small shops and firms have been sold by auction since the late 1980s. Very few remain
in state hands.

Based on sales to date plus GoH expectations of future proceeds, the market value of total assets was
probably about US$ 13-15 billion.
Additional transactions have involved (i) the free transfer of properties to Social Security Funds and to individuals holding compensation vouchers; and (ii) employee and management buyouts when no outside investors placed bids. The top priority throughout has been cash sales and maximized proceeds at the expense of speed. This has resulted in the retention of state properties to (i) restructure them before privatization in the hope of maximizing sales revenues; and (ii) minimize social dislocation (unemployment, reduced compensation and benefits) that often occur with needed enterprise restructuring.

Hungary adopted legislation in 1992 to provide a legal framework for privatization. This legislation provided for establishment of the State Property Agency (AVU) to handle small- and medium-scale enterprise privatization, and the State Holding Company (AVRt) to manage larger enterprise transactions. Additional laws and privatization tools to broaden distribution of ownership have involved (i) a "pre-privatization program" from 1990-1994 to privatize 9,800 small-scale enterprises (nearly US$ 200 million in assets); (ii) a subsidized, long-term loan scheme (about US$ 600 million in 15-year loans at 3-4 percent interest); (iii) employee stock ownership since 1992 (194 cases by October 1994 at about US$ 400 million in assets); (iv) restitution in the form of a compensation scheme (issuance of about US$ 650 million in notes to purchase loans, apartments, or shares in properties owned by AVU or AVRt); (v) a leasing scheme since 1993 (33 transactions of about US$ 100 million in 10-year leases); and (vi) a preferential share purchase program permitting installment payments for shares over a five-year period. However, despite efforts to stimulate more broadly based domestic investment in large- and medium-scale privatization, Hungary only had 1.2 million shareholders by end 1994.174 AVU had divested about US$ 8 billion in assets, or three-quarters of its initial holdings of enterprise equity in 1,661 enterprises by end 1994. However, AVRt had divested only US$ 1.5 billion, or less than one-tenth of its initial holdings in 171 enterprises. Thus, privatization and liquidation have proceeded at a reasonable pace at the smaller end, but slowly with the largest SOEs which are responsible for the largest losses. The new Privatization Law and mid-1995 GoH announcement to at least partially privatize companies in the oil and gas, power generation, and telecommunications sectors indicate Hungary expects to accelerate the privatization of large-scale enterprises (see "C3. The Remaining State Sector"). Privatization targets for end 1997 include divestiture of about HUF 700 billion (about US$ 5 billion) in state holdings, about half of current state equity holdings. Specific targets for this period include (i) privatization of majority ownership in Antenna Hungaria (broadcasting), four regional gas distribution companies, and five power distribution companies; (ii) invitation to tender for at least two of six major power generation enterprises; (iii) privatization of at least 30 percent of MOL; and (iv) reduction of state ownership in MATAV to 35 percent or less.

Poland

Poland has followed a gradualist, multi-track approach to privatization. On the one hand, Poland has sold or liquidated about 40 percent of SOEs since 1990175, equivalent to about 50 percent of book valued assets (estimated originally to be US$ 58 million). On the other hand, more than 5,000 SOEs

174 With a population of 10 million and about 7 million potential shareholders, this represents limited participation in the privatization process. By contrast, in the other Visegrad countries, mass privatization programs typically involve at least 70 percent of the eligible population.

175 Ministry of Privatization statistics show Poland had 8,441 registered SOEs in 1990, of which 3,269 had been privatized as of June 30, 1995.
remain in state hands. Methods of privatization have generally involved (i) the liquidation of non-viable enterprises; (ii) employee and management buyouts of smaller and mid-sized enterprises in adequate financial standing; and (iii) direct sales of larger enterprises to management, employees, or outside investors. By June 1995, (i) 1,319 enterprises in poor financial standing had been liquidated (under Article 19 of the State Enterprise Act); (ii) 1,116 small and medium-sized enterprises had been privatized, mostly through lease arrangements to managers and/or employees (under Article 37 of the Law on Privatization of State-owned Enterprises); and (iii) 834 mid-sized and larger enterprises had gone through the "commercialization" process (become a joint-stock or limited liability company), with most (413) of these participating in mass privatization and an additional 142 having been sold to strategic investors ("capital privatization").

Poland conceptualized privatization as early as 1988 to (i) improve the performance of the enterprise sector; (ii) reduce the size of the public sector; and (iii) encourage broad-based ownership. Key considerations at the outset of the initial post-communist period were (i) integrating a privatization strategy into the macroeconomic stabilization program ("shock therapy") intended to transform Poland's economy to a market economy; and (ii) preparing a Privatization Law to accommodate these changes. The Law on Privatization of State-owned Enterprises was ratified in July 1990 to regulate procedures during the transformation of a state enterprise to joint-stock or limited liability status. To broaden participation, the law granted workers the right to gradual purchases of company assets, and to 20 percent of shares set aside at preferential (half-price) rates. The Law called for a multi-track approach consisting of public offerings, direct sales, management and employee buyouts, and mass privatization through a voucher scheme. However, the law left the privatization process to the discretion of employees, set

---

176 In mid-1995, the Ministry of Privatization estimated the value of remaining state properties to be in excess of OZ 650,000 billion (about US$ 26 billion), consisting of the following: (i) 4,000 enterprises with no privatization plan (OZ 389,000 billion); (ii) 502 State Treasury companies, or JSSPs (OZ 183,000 billion); (iii) 400 companies allocated to NIFs (OZ 15,000 billion); (iv) 30 enterprises nearly privatized (OZ 21,000 billion); (v) 3 insurance companies (OZ 43,500 billion); and (vi) 11 state banks (no value specified). Subsequent estimates placed the value at about US$ 23.5 billion.

177 This represents 40 percent of total privatization transactions as of June 1995.

178 781 of 1,079 privatizations under Article 37 were lease-arranged buyouts by April 1995. This represents 72 percent of Article 37 privatization transactions, and 25 percent of total privatization transactions.

179 Another 101 enterprises were added to the mass privatization pool in August 1995. An additional 86 are currently being considered as a third tranche. However, the Ministry of Privatization considers 600 enterprises to be maximum capacity for the existing 15 National Investment Funds participating in the mass privatization program.


181 Public offerings have been discouraged by a 0.2 percent tax on Warsaw Stock Exchange transactions, although this tax was suspended and not set to resume until mid- to late-1995.
no timetables, and provided employees with incentives to delay the privatization process. With annual turnover of governments since 1990, these weaknesses combined with political factors have contributed to the slowdown of privatization in Poland.

There is still no indication that privatization will accelerate soon, although efforts are being made to increase the number of companies included in mass privatization to 600 (from the original 413). A total of about 360 enterprises are targeted for privatization in 1996, about the same as occurred in 1995. A Constitutional Tribunal recently decided against the constitutionality of the recently proposed Law on Commercialization and Privatization which was adopted by Parliament on June 30, 1995, subsequently vetoed by the President, and then re-approved by Parliament on July 21, 1995 over the presidential veto. Weaknesses in the previously proposed law abounded. While state enterprises would have fallen within the framework of the Commercial Code (as joint-stock or limited liability companies), the law would have increased the chances that mass commercialization would occur as a substitute for privatization. A revival of some modified form of the law is possible. If this occurs, 3,000-4,000 SOEs could be commercialized without specified objectives, methods or timetables for privatization. This, in turn, could perpetuate state ownership in the economy, increase the role of the State Treasury in the corporate governance of these enterprises, and possibly lead to the formation of holding companies in troubled and protected industrial sectors (coal, steel). Specific weaknesses in the law included (i) the need for parliamentary approval for the privatization of banks, insurance companies, and enterprises in the oil, petroleum, chemicals, coal, steel, telecommunications, airlines, and other "strategic" sectors, all of which would undoubtedly cause delays; (ii) increasing the number of government institutions involved in the privatization process; and (iii) requiring approval of the Council of Ministers for the commercialization of each state enterprise. While Poland has significantly cut government subsidies to loss-making enterprises and banks have curtailed lending to these same enterprises (see Section IV), Poland’s retention of more than 5,000 SOEs has constrained broader private ownership and contribution to GDP.

182 Amendments to the Privatization Law were supposed to include privatization/transformation deadlines without requiring employee approval. However, preparation and submission of these amendments to Parliament have been repeatedly postponed. This, in turn, has encouraged SOE employees to wait until legislation is passed in anticipation of more favorable buyout conditions.

183 As of September 1995, unofficial privatization targets for 1996 included (i) 90 individual sales ("indirect privatization") via trade sales based on public invitations, public offerings, and tenders; (ii) 150-200 sales, mergers and lease arrangements ("direct privatization"); and (iii) 70 debt-equity swaps.

184 The ruling coalition recently agreed that the Ministry of Privatization could direct privatization transactions in the tobacco and copper mining sectors. However, even here, there are severe conditions placed on prospective investors. For example, tobacco processors will be required to ensure that final products use a minimum 40 percent of Polish tobacco, despite being expensive and of comparatively low quality. Foreign investors are allowed no more than a 33 percent share, compared to domestic investors which are permitted to bid for up to 55 percent shares. In the copper mining sector, only 25 percent of shares will be available to private investors. The balance will be held (i) 51 percent by the state; (ii) 15 percent by the workers; and (iii) 9 percent for pension funding and restitution claims.


69
Slovak Republic

The Slovak Republic has experienced two stages of privatization: rapid and mass privatization during the first wave of the CSFR period, and stagnation since mid-1993 when the first wave ended. The Slovak Republic began with about 2,000 SOEs, with estimated book value of K 1,100 billion (about US$ 38 billion). The first wave of privatization was covered by two laws regarding privatization passed in the CSFR: (i) "small privatization" (December 1990), which applied to 9,300 shops, restaurants and other small enterprises sold by local authorities through public auctions, generating SK 14 billion (about US$ 0.5 billion) in proceeds; and (ii) "large privatization" (June 1991), which applied to more than 500 larger enterprises with book value of SK 167 billion (about US$ 5 billion), and resulted in sales proceeds of SK 14.5 billion (US$ 0.5 million) from 751 "first wave" privatization transactions (direct sales, competitive tenders, cash auctions, vouchers, restitution, liquidation). The first wave made significant progress toward containing losses and fiscal subsidies. Voucher privatization and the privatization of small shops, restaurants and other small-scale service sector enterprises also succeeded in creating broad-based ownership of assets that were privatized.

However, progress has very much stopped since 1993. The second wave of privatization was originally (September 1993) going to include most productive enterprises remaining in state hands. This equated with 519 enterprises with book values approximating SK 200 billion (US$ 6.5 billion) in total. Of this, about 15 percent (US$ 1 billion) consisted of 365 companies with book values of less than SK 250 million (US$ 8 million). The remaining 85 percent (US$ 5.5 billion) comprised 154 companies. Most companies were to be sold directly to the market by public tender, with some use of voucher privatization in the case of larger companies. This ran the risk of slowing down the privatization process, a departure from the first wave. The next government altered these plans (March 1994), reviving voucher privatization as a more widely used method of privatization to maintain speed as a top priority. More recently, a subsequent government announced that it was terminating all plans for the second wave of privatization to proceed. Instead, GoS plans to provide SK 10,000 bonds to the 3.5 million citizens who had already signed up for and bought vouchers for the second wave of coupon privatization.

Many analysts believe there are several problems with the Slovak Republic’s privatization program: (i) unsuitable property rights for a market economy undermine investment (see Section II); (ii) failure to restructure/privatize its most costly loss-makers in the industrial sector; and (iii) the privatization process has become highly politicized, as successive governments have attempted to reverse privatization transactions agreed to by previous governments. With weakened corporate governance

Figures derived from opening totals from Czechoslovakia less opening totals for the Czech Republic. See Yudit Kiss, "Privatization Paradoxes in East Central Europe", 1994.

Among the larger companies with book values in excess of SK 250 million, (i) 86 had book values up to SK 500 million (US$ 16 million); (ii) 37 had book values between SK 0.5-1.0 billion (US$ 16-32 million); and (iii) 31 had book values in excess of SK 1 billion (US$ 32 million).

The current government in the Slovak Republic announced it was reversing 50 privatization agreements agreed to in/before October 1994 by the previous government. In May 1995, the Constitutional Court blocked this attempted reversal, claiming Parliament had acted beyond its constitutional powers. Such political moves and legal proceedings have significantly slowed privatization progress in the Slovak Republic. This was preceded by the previous government’s attempts to reverse 40 other direct sales to those loyal to the preceding government. This (continued...
from IPFs, more extensive state control in the economy, and enhanced prospects for abuse, recent developments do not bode well for the Slovak Republic's privatization prospects.

C. General Results of Enterprise Privatization in the Visegrad Countries

1. Summary

Box 7 provides a brief summary of Visegrad privatization results. Overall, the Visegrad countries have privatized more than 170,000 state enterprises with an estimated US$ 75 billion in book values. Proceeds generated from privatization have approximated US$ 10 billion, about 15 percent of the book value of privatized assets. The difference is due to (i) non-cash transactions (usually voucher privatization) that have been used by all Visegrad countries to broaden the base of ownership; and (ii) inaccurate valuations relative to market values due to outdated accounting principles (at the time book values were estimated), and insufficient information to project enterprise cash flows.

The Czech Republic has been the most active country, privatizing (at least partially) 80-90 percent of its SOEs and conducting more than 6,700 "large-scale" privatization transactions since late 1990. The Czech Republic has pursued a program emphasizing speed and broad-based distribution, and has generally succeeded in achieving objectives. Hungary has privatized nearly 1,000 enterprises and liquidated about 500, all accounting for about one-third of original book asset values. Transactions have been evenly divided between direct sales and non-cash methods (vouchers, buyouts via deferred payment). GoH has focused on value and broad-based distribution. Aside from a few large-scale privatizations, most transactions have been well below book value. Likewise, with only 1.2 million shareholders, the government has not succeeded in broadening the base of ownership (although the private sector as a whole has grown, as in Poland). Poland has privatized, divested or liquidated about 3,300 SOEs, mostly on a non-cash or deferred payment basis (about three-quarters of privatization transactions have been... continued)

...continued

performance is in stark contrast to the Czech Republic, which completed its second wave of privatization in early 1995 and has about 80 percent ownership (at least partial) of assets by the private sector.

The new GoS position on privatization also (i) extends full state control over "strategic" enterprises (which include telecommunications, gas and defense industries); and (ii) extends NPF control indefinitely in firms in which it has an equity stake, even when this represents minority ownership.

Prospects for abuse are given more credence because (i) the bonds will not mature until 2001, after the current government's term expires; and (ii) political allies who benefitted from NPF "privatization" will be able to use NPF bonds to "repay" the NPF for the privatization shares they received, thus making it a free transfer of assets from the state to the beneficiaries.

This includes (i) 22,000 small-scale "units" (restaurants, shops) and 3,000 larger enterprises in the Czech Republic; (ii) 9,600 small-scale enterprises and 1,460 medium-and-large-scale enterprises in Hungary; (iii) 120,000 small enterprises and 3,269 medium-and-large-scale enterprises in Poland; and (iv) another 9,300 small-scale businesses auctioned off in the Slovak Republic, and 500 larger enterprises.

Estimates show the Czech Republic and Hungary have generated about US$ 4 billion in cash proceeds from privatization, Poland has generated about US$ 1 billion, and the Slovak Republic has generated about US$ 500 million.
liquidations, buyouts through lease agreements, or non-cash transactions). Poland has focused on broad-based ownership and value as objectives, but has not succeeded in achieving either objective (although the private sector as a whole has grown, as in Hungary). The Slovak Republic has privatized approximately 10,000 SOEs, mostly small shops. There have been about 750 "large-scale" transactions. As in the Czech Republic, the objective was speed and distribution, both of which were achieved in the first wave. Now, the objective appears to be to retain state involvement in the industrial sector, disperse ownership, and entrench existing management. The objective of retaining at least partial state control of Slovak industry appears to be firm. Privatization results in the Visegrad countries are discussed in greater detail below.

| Box 7: Summary of Non-Microenterprise Privatization Results in Visegrad Countries |
|---------------------------------|---------------------------------|-------------------------------|-------------------------------|
| **Czech Republic**               | **Hungary**                     | **Poland**                    | **Slovak Republic**           |
| **Number of Privatized SOEs**    | 5,200 of 5,400 SOEs privatized in two waves | 653 SOEs wholly privatized, 271 SOEs partially privatized, 536 SOEs liquidated since 1991 | 3,173 of 8,441 SOEs privatized, divested or liquidated | About 750 large enterprises in the first wave; second wave cancelled |
| **Value of Privatized SOEs**     | K 1 trillion, or about US$ 30 billion (60% of estimated book values for all SOEs) | HUF 350 billion in cash, or US$ 3.0-3.5 billion; an additional HUF 170 billion has been in non-cash transactions | About US$ 1 billion | KS 167 billion (book value), o/w KS 14.5 billion in cash sales, or US$ 500 million |
| **Types of Privatization Transactions** | - Direct sales | - Direct sales | - Direct sales | - Direct sales |
|                                  | - Mass privatization (coupon scheme) | - Management +/or Employee buyouts | - Management +/or Employee buyouts | - Mass privatization (coupon scheme) |
|                                  | - Management +/or Employee buyouts | - Public offerings | - Public offerings | - Management +/or Employee buyouts |
|                                  | - Public offerings | - Liquidations | - Liquidations | - Public offerings |
|                                  | - Liquidations | - Legal Corporatizations | - Corporatizations | - Liquidations |
|                                  | - Free transfers to municipalities | - Foreign participation in SOEs | - Foreign participation in SOEs | - Free transfers to municipalities |
|                                  | - Corporatization | - SOE ventures with foreign participation | - | - Corporatization |
|                                  | - SOE ventures with foreign participation | | | - SOE ventures with foreign participation |

2. Country Reviews of Enterprise Privatization

Czech Republic

The results of the Czech Republic's/CSFR privatization program have been consistent with mass privatization: fast, relieving fiscal pressure, and encouraging broad ownership. To achieve this, CSFR clarified and amended ownership and property rights in 1990. At the time rapid privatization goals were set, the government wanted 85-90 percent of assets in private hands by 1994. In early 1995, private sector ownership was estimated at about 80 percent\(^\text{193}\) of assets (and 65 percent of GDP) with the closing of the second wave of privatization. Hence, the government has been effective at achieving its targets. With more than 6 million Czechs trading vouchers, and many other domestic and foreign investors participating, the Czechs will have privatized more than 25,000 total enterprises (including small shops, restaurants) within five years, accounting for virtually the entire enterprise sector.

About 200 enterprises remain in public hands with the National Property Fund, valued at K 194 billion (nearly US$ 7 billion). Of these, about two-thirds of the asset values are being held temporarily, consisting of big blocks of shares in major companies that have already been partially privatized. These include banks, insurance companies, CEZ (Czech power company), metallurgy, and mining. A smaller block of companies with assets valued at K 68 billion (nearly US$ 2.5 billion) are to be permanently retained. This includes the partly privatized national airline, CSA. Particularly worrisome is the structure of cross-ownership between SOCBs, Investment Privatization Funds, and several large enterprises. As formerly state-owned banks\(^\text{194}\) routinely report non-performing loans of about 25-30 percent of their total portfolios, there is concern that the restructuring needs of many of the enterprises retained by the National Property Fund could drain bank (and possibly fiscal) resources to the detriment of private sector growth. By end 1994, three small banks had failed, and two of the Czech Republic’s largest banks reported non-performing loans of 25-30 percent. In general, bank net interest margins are declining as foreign banks introduce greater competition in the marketplace. Reduced net interest margins leave Czech banks with less cushion to absorb losses from sub-prime Czech companies. For this reason, many analysts believe the restructuring needs of the enterprise sector are bound to become increasingly evident in the near future. With "mutual insolvency" approximating K 150 billion (US$ 5 billion)\(^\text{195}\) and non-performing loans estimated to approximate another K 150 billion (US$ 5 billion), the total cost of

\(^{193}\) This figure is used with caution. Much Czech privatization has involved only partial sell-offs, with continued non-private holdings in "private" enterprises. However, according to the Czech National Property Fund, (i) 79 percent of assets earmarked for privatization have been fully privatized; and (ii) of the remaining 21-22 percent of assets, three-quarters (15-16 percent) are composed of shares from the National Property Fund, of which 72 percent (11-12 percent) have already been privatized "partially". Thus, on an asset basis, it appears the Czech economy is more than 80 percent owned by the private sector. However, with only 65 percent of GDP produced by the private sector, the state continues to hold significant stakes (directly and indirectly) in many large enterprises.

\(^{194}\) The four ex-state banks are Obchodni Banka (foreign exchange for enterprises), Ceska Sporitelna (savings), Komercni Banka (commercial accounts for enterprises) and Investicni Banka (large industrial projects and housing). The state (through NPF) has retained 30-45 percent ownership in these four specialized ex-state banks, although they have technically been privatized. While specialization is beginning to decline (Ceska Sporitelna is lending to enterprises; Obchodni and Investicni are mobilizing deposits), diversification is still somewhat limited.

\(^{195}\) Other estimates go as high as K 400 billion (US$ 13 billion), about 39 percent of 1994 GDP.
correcting these problems would approximate 30 percent of 1994 GDP. While the Czech Republic has shown fiscal prudence during the transition, the limited use of bankruptcy and liquidation (see Section II) to restructure SOEs raises the risk that formerly state-owned banks have been and will be used by the state to defer or postpone needed restructuring in key industrial sectors (metallurgy, mining). This would indicate that in "strategic" sectors, the state might exercise far more influence in the economy than is otherwise interpreted from private sector asset-ownership and GDP figures. Box 8 summarizes privatization highlights in the Czech Republic since 1990.

**Box 8: Privatization in the Czech Republic**

*Stock of SOEs:* The Czech Republic began with 5,400 SOEs, with an estimated book value of K 1.5 trillion (US$50 billion).

*Privatized SOEs:* While numbers are sometimes inconsistent due to varied definitions of privatization, the Czech Republic privatized 2,404 SOEs (book value: K550 billion) during the first wave, and about 2,800 SOEs (book value: K450 billion) in the second wave. About one third of privatizations were through vouchers.

*Value of Privatization Transactions:* The estimated book value of privatization transactions is K1 trillion (US$ 30 billion).

*Types of Transactions:* Total transactions approximate 6,400, as follows:

- 1,936 direct sales (K61 billion in book value)
- 988 mass privatizations via vouchers (K198 billion in book value)
- 633 management +/or employee buyouts (K18 billion in book value)
- 7 public offerings
- 352 liquidations
- 1,150 properties transferred free to municipalities (K11 billion in book value)
- 1,249 corporatizations (restructuring prior to privatization); and
- 102 SOEs with foreign participation (K11.7 billion).

In the end, nearly six million Czechs registered for coupons for mass privatization, about 80 percent of the eligible Czech population.

*Sector Distribution of Privatized SOEs:* All sectors, with the largest number of enterprises in building and engineering (341) and the food industry (87). In terms of book value, the major sectors were banking (K 6.4 billion), electrical power and heat (K 3.8 billion), iron and steel (K 2.2 billion), insurance (K 1.8 billion), pulp and paper (K 1.5 billion), foreign trade (K 1.2 billion), and metalworking (K 1.1 billion).


**Hungary**

While Hungary has been somewhat of a maverick in the region with regard to infrastructure privatization (airlines, telecommunications, oil) and deregulation (road transport, cellular phones), in many troubled industrial sub-sectors, privatization has been gradual at best. A total of 924 larger enterprises have been totally or partially sold, and 536 enterprises liquidated. Privatization sales have generated about US$ 3.5 billion in cash. Another 740 SOEs remain to be privatized with an estimated value of about US$ 5 billion. Most of Hungary's privatizations have been at the smaller end by the State Property Agency (AVU), which has done an adequate job of privatizing smaller enterprises. However, the State Holding Company (AVRt) had only divested 9 percent of its equity holdings by end 1994, involving 36 of 171 companies. Of the 36, 13 were via liquidation and 23 were only partially sold. It is here that many of the problems lie with Hungary's privatization program, as the large-scale enterprises in AVRt's portfolio have been the loss-generating firms which have adversely affected Hungary's monetary and fiscal balance and contributed to the bad loan portfolios of the state-owned banks.
Faced with mounting public debt and fiscal deficits, failed bank recapitalizations, and a slowdown in privatization transactions, Parliament adopted a revised Privatization Law in May 1995 to accelerate privatization, contain SOE losses financed by the public sector, and maximize privatization proceeds to reduce the stock of public debt. The new law (i) merges AVU and AVRt into the State Privatization and Property Management Agency (APVRt); (ii) makes privatization the clear priority (rather than restructuring); (iii) lists the firms to be retained by the state (nuclear plant, power grid, railways); (iv) includes banks and large industrial companies on the privatization list that were earlier to be retained for an indefinite period by the state; and (v) places cash sales as the preferred method of transaction via auctions and tenders (above discounted transactions such as leasing, employee stock ownership) while providing opportunities for owners, managers and employees to acquire remaining stakes in companies in which they hold majority shares. GoH announced plans for at least partial privatization of several major companies in May 1995, and has already attracted more foreign investment than in 1994. Although the law still provides GoH with opportunities for delays and reversals of privatization decisions, as well as continued intervention after privatization with the use of golden shares and partial privatizations, GoH appears intent on divesting about 80 percent of remaining state equity in more than 700 companies held in APVRt’s existing portfolio by end 1997. If so, Hungary has good prospects for reducing fiscal deficits and public debt, and increasing economic growth and private sector competitiveness.

---

196 External debt was 71 percent of 1994 GDP, compared to 60 percent in 1992. The fiscal deficit in 1994 was nearly 7 percent of GDP, compared with surplus in 1990.

197 The retention of loss-making SOEs has drained the liquidity and capital of SOCBs, which in turn have had to turn to the government budget for recapitalization four times in recent years. Recapitalization has cost the budget more than US$ 3.2 billion, or about 7.5 percent of 1994 GDP.

198 In 1994, Hungary generated only US$ 300 million in privatization proceeds, about 20 percent of target. As these revenues were written directly into the 1994 budget, failure to achieve such targets added to the fiscal deficit. This only puts added pressure on the government to sell SOEs to reduce the already problematic fiscal deficit, giving a negotiating advantage to prospective buyers and, consequently, reducing government leverage in maximizing sales prices.

199 MOL, the state oil and gas company, will become 75 percent private. MVH, the electricity company, will have 50 percent of its national distribution center, 50 percent of its non-nuclear power company, and 100 percent of its regional electricity companies privatized; GoH will retain control of the nuclear plant and national grid system, and will have a “golden share” in the regional electricity companies. Regional gas supply companies will be 100 percent privatized (less one golden share).

200 MATAV, the telecommunications company, alone attracted US$ 500 million in 1995.
Box 9: Privatization in Hungary

Stock of SOEs: Hungary began with about 2,200 SOEs, with estimated book value of HUF 2.8 trillion (about US$ 3.0 billion).

Privatized SOEs: 924 SOEs have been privatized or "corporatized". Another 536 have been liquidated. Combined with new businesses, at least 50 percent of assets are in private hands now. New private enterprises account for about two thirds of investment in fixed capital.

Value of Privatization Transactions: Privatization revenues amounted to HUF 426 billion between 1990-1994, of which about 60 percent has been in cash. This amounts to HUF 277 million (about US$ 2.8 million) per privatization transaction when excluding liquidated companies.

Types of Transactions: Total transactions approximate 1,460, as follows:
- 653 total privatizations (HUF 206 billion)
- 271 partial privatizations (HUF 285 billion)
- 536 liquidations (HUF 337 billion)

Sector Distribution of Privatized SOEs: Privatized enterprises have been primarily in the small and medium-scale sectors in all production endeavors. Non-privatized SOEs have generally been large-scale in energy, infrastructure, industry, agriculture and forestry, research and development, and finance. At end 1994, the State Property Agency had divested 1,424 of 1,841 SOEs. The State Holding Company had divested 36 of 171 enterprises. Another 86 enterprises were retained by other bodies.


Poland

The GoP has succeeded in selling most of the smaller commercial trade, retail shop and other quick-return activities found in the service sector. With agricultural land kept primarily private even during the era of central planning, the private sector is now firmly established in most sectors of the economy. However, as in Hungary, privatization in Poland has proceeded slowly in the medium- and large-scale industrial sectors (mining and manufacturing). As a result, more than 5,000 SOEs remain, with an estimated 50 percent share of 1994 industrial output and about 60 percent of end-1994 employment in companies with greater than 5 employees.\(^{201}\)

While Poland exceeded its limited targets for direct sales by end 1994 (135 sales against 110 targeted), privatization otherwise lagged earlier targets by end 1994: (i) 2,289 liquidations against a target of up to 3,090; (ii) zero mass privatizations against a target of 400-600; and (iii) 713 commercializations against a target of up to 1,700. Mass privatization was finally approved in 1994 and launched in 1995, so progress is clearly being made in this domain (see Box 11). However, commercialization and liquidation figures still remain in arrears. While GoP is expected in 1995 to meet minimum privatization targets originally set for 1994, there is still the risk of GoP delaying privatization (see "B2. Country Reviews of Privatization Laws and Methodologies").

Significant public skepticism of privatization and foreign investment has persisted in Poland during a period of reduced job security, less secure social benefits, changing income distribution patterns, and general economic transition. The issue of "worker equity" has slowed the process, while differing approaches to enterprise ownership and performance, conflicts between the central government and

---

\(^{201}\) Approximately 15 million people were employed in Poland at end 1994, including about 5 million sole proprietors (individual owner-operators). Of the remaining 10 million, there were 2.5 million more employed by the state sector than the private sector. Hence, about 62.5 percent of the balance employed by companies with greater than 5 employees, but only 42 percent of total employment.
voivods, and raw electoral politics have prevented rapid privatization since 1992. Employees have essentially maintained the right to refuse ownership transformation (to joint-stock or limited liability status), and have been entitled to free and half-price shares guaranteed upon privatization of an enterprise. Delays in amendments to privatization legislation have also provided incentives to employees to defer needed restructuring or privatization (see "B2. Country Reviews of Privatization Laws and Methodologies").

**Box 10: Privatization in Poland**


Privatized SOEs: Poland has privatized, commercialized or liquidated about 3,173 SOEs, of which about one-third have been through dissolution or bankruptcy. Privatizations have often occurred by selling/leasing assets to managers or employees. Only 138 SOEs have been sold to strategic investors. Few sales have been made through the stock exchange, although the trend is expected to improve. Another 514 SOEs are included in the mass privatization program, with another 86 commercialized enterprises to follow.

Value of Privatization Transactions: By September 1994, privatization revenues approximated US$ 330 million, which was greater than the figure for all of 1993. Total transaction value has almost certainly been less than US$ 1 billion.

Types of Transactions: Total privatizations from 1990-April 1995 include:

- 1,281 liquidations
- 1,079 SME transactions
- 813 conversions to joint-stock company status ("commercialization")
- 138 sales to strategic investors for about US$ 300 million ("capital privatization")

About 700 of these transactions have been management +/or employee buyouts, usually following liquidation. There have been 16 public offerings for US$ 64 million. Foreign participation in 38 SOEs (US$337 million) include employment guarantees for 30,500 people and investment guarantees of US$ 352 million.

Sector Distribution of Privatized SOEs: Most sectors except defense, oil and gas, telecommunications, banks, insurance, and mining.

Sources: Ministry of Privatization; internal World Bank reports; Oxford Analytica; Business Update Poland.

Distribution, rather than speed and value, has been the key objective of Poland’s privatization strategy. Privatization has long been viewed by GoP as a method to improve national economic performance and increase state proceeds, rather than as an objective in itself to accelerate private sector

---

202 By type of privatization transaction, all categories (commercialization, privatization of SMEs under Article 37 of the Law on Privatization, liquidation of SOEs under Article 19 of the State Enterprise Act) began to decline in 1992. "Capital privatizations", or direct sales to strategic investors (a form of "commercialization" in Poland), increased slightly, but only from 24 in 1992 to 48 in 1993. Only 142 of these transactions had been finalized by June 30, 1995. Part of this reflects sentiment opposed to FDI.

203 Valuation of leased assets has been of critical importance to the prospects of the enterprise. In some cases, the fixed asset values have been low, leading to low lease amortization payments which have given the new owners a chance to generate strong cash flow, and in some cases reinvest in the firm for future growth. When fixed assets have been overvalued, lease payments have been high, draining cash flow. This has caused considerable resentment, and undermined enterprise prospects for long-term competitiveness. Legislation is currently under consideration to permit enterprises to gain title to leased assets after 30 percent of the principal value is paid down, compared to the current practice of requiring full repayment before title is transferred.

204 These include 781 lease-based transactions, 181 direct sales, 51 joint ventures, and 66 others.
competitiveness. Consequently, Poland has generated less than US$ 1 billion in proceeds from privatization sales, about 4 percent relative to the US$ 25 billion or so in book valued assets divested. From 1990 to mid-1995, Poland had about 834 "commercialized" transactions (less than 10 percent of total registered SOEs in 1990) involving 12-15 percent of book valued assets. About half of these enterprises have been included in the mass privatization program. There have been 142 "capital privatizations" (direct sales to strategic investors, usually foreign companies), which partly explains Poland’s sub-standard performance in attracting FDI (see Sections II and IV). Only a handful of public flotations have occurred (16 as of mid-1994), although mass privatization will accelerate capital markets development (Warsaw Stock Exchange, OTC market) in the coming years.

Most of Poland’s privatization transactions have involved "liquidation". By mid-1995, (i) 1,319 enterprises in poor financial standing had been liquidated, accounting for about 40 percent of total privatization transactions; and (ii) 1,116 small and medium-sized enterprises in better financial standing had been privatized, representing another 25 percent of privatization transactions. Consistent with the GoP privatization objective of ensuring a wide diffusion of ownership of privatized assets, about three-quarters of the SME privatizations (through liquidation) have been through lease arrangements to managers and/or employees. However, these transactions have been far less efficient in creating new jobs, often because the bought out company has problems expanding and competing. This is due to (i) difficulties in meeting lease payment requirements, which weaken cash flow; (ii) the quality of leased assets, which are already beyond their useful lives and of inferior quality compared to new technologies; (iii) inability to collateralize leased assets, as title to the assets is not transferred until the lease is fully repaid; and (iv) in the case of many employee buyouts, management skills are weak and corporate governance is ineffective because of diffused ownership.

---

205 From 1991-1993, there were 693 of these buyouts which transferred 200,000 jobs from State to private status. (An additional 100 or so buyouts have been transacted since.) This compares with private sector creation of 3.5 million new jobs, mostly in the service sector, during the same period (1991-1993).

206 Reforming lease practices to allow transfer of title before full lease payments are made is currently under consideration in Poland.
Box 11: Poland's Mass Privatization Program

Poland's mass privatization program (MPP) is designed to restructure troubled enterprises via foreign capital and expertise, while providing an ownership structure that is Polish. At least 15 National Investment Funds (NIFs) will hold equity in and restructure 514 small- and medium-scale SOEs with total book value of 0Z 70 trillion, or about US$ 3.0 billion (average book value of about US$6 million). (By comparison, the Czech mass privatization program included companies valued at book at about 30 percent of GDP, or about US$ 7.5 billion at the time.) These firms account for an estimated 10 percent of Polish output, which would approximate sales of about US$ 22 million based on estimated 1994 GDP of US$ 92 billion. Of the 514 firms, nearly 200 have sales of less than US$ 5 million, and about 20-30 have sales significantly more than the average. Each NIF has received 33 percent equity in about 35 firms, and up to 2 percent in the other 480 or so firms. The selection of firms was random once NIFs drew lots for the sequencing of firm selection. As a whole, targeted enterprises are owned 60 percent by NIFs, 25 percent by the Treasury, and 15 percent by employees.

"Universal share certificates" (bearer certificates) were for sale to up to 28 million Polish adults in late 1995, with equal stakes in each of the 15 NIFs. These certificates were sold for the equivalent of 40 percent of the national average salary. Pensioners and public sector employees received bonus compensation coupons at no charge. NIF shares will be listed as closed-end funds on the Warsaw Stock Exchange in 1996, nearly doubling stock market capitalization (about US$ 4 billion in mid-1995). Universal share certificates will then be convertible into NIF shares. The NIFs are working in consortium arrangements with Western firms for a period of 10 years to restructure the enterprises. The consortia will receive compensation for start-up and initial operating costs (EBRD is investing US$ 3.2 million in each NIF to defray these costs), 15 percent cash equivalent of equity, and fees of 1 percent per year and a 5 percent fee at the end of the period. NIFs will not be able to sell their shares for at least three years.

Sources: Privatization International; Euromoney; World Bank staff estimates.

Slovak Republic

The Slovak Republic's approach to privatization has been mass privatization followed by virtual stoppage, largely correlated with the CSFR and post-CSFR periods. During the first wave, 2.6 million eligible Slovaks (about three-quarters of total) participated in mass privatization. About one-third of companies were sold through direct sales, and the rest through other means, including vouchers. Virtually 75-80 percent of Slovakia's small-scale enterprises were privatized by mid-1994 (9,300 small shops auctioned off or returned to the original owners). Half of the country’s medium- and large-scale enterprises were privatized in the first wave, mostly via mass privatization and the voucher scheme ending in 1993. Since then, the Slovak Republic’s privatization program has come to a halt.

The current government was originally expected to proceed with privatization by creating more than 1,000 transactions from 559 companies with book values of SK 223 billion (about US$ 7.5 billion). However, most transactions were to involve the conversion of SOEs to joint stock companies, with the National Property Fund expected to retain about 40 percent of total value. The original plan to privatize SK 80 billion in SOEs by voucher was subsequently reversed, although 3.5 million Slovaks (about two-thirds of the total population) had signed up to participate. By end 1994, about 80 percent of citizens purchased privatization vouchers for the second wave of privatization, which was expected to privatize about SK 200 billion (US$ 6-7 billion) in assets. Based on a 1991 government decree, the second wave was delayed for domestic political reasons, and subsequently cancelled by Parliament in July 1995. GoS now plans to provide SK 10,000 bonds to the 3.5 million citizens wishing to participate, who can then use these bonds for direct purchases of SK 35 billion (US$ 1 billion) in state housing and shares in SOEs administered by the NPF.207 The bonds to be distributed to coupon holders will be in denominations of SK 10,000 (about US$ 350) and payable after five years. These are to be exchanged for SK 35 billion (US$ 1.2 billion) in properties currently held by NPF, about one-sixth of what was originally planned to be sold in the second wave of privatization. Another SK 90 billion in assets will likely stay in the NPF for at least 2-3 years (no privatization track identified), most of it permanently. Apart from bond-related transactions, NPF is expected to focus on (i) direct sales, without a clear declaration of fast-track

207 The bonds carry an interest rate equal to the discount rate to offset any inflationary effects.
(Treuhand) or slow-track (Hungary) approaches; and (ii) management and employee buyouts, linked when possible to strategic investors. The termination of voucher privatization is expected to bypass IPFs as intermediaries and reinforce management. Management buyouts are designed to be put on favorable, deferred payment bases (10 percent down, 90 percent over 10 years).

While GoS claims to want to increase the number of citizen shareholders, the real objectives appear to be to (i) strengthen enterprise managers (often political allies of the current government) by dispersing share ownership and undercutting the ability of IPFs to exert influence on corporate governance; and (ii) reinforcing the role of the state in the economy. IPFs, while not always effective in exercising corporate governance, will have their influence reduced by the required direct use of bonds by citizens in purchasing assets (as opposed to investing in IPFs, which then exert influence from supervisory boards on behalf of their shareholders). Direct transactions will disperse share ownership in companies, reinforcing management positions. There are discussions currently underway to limit IPF ownership to 10 percent in any one company. Legislation on investment firms and Funds passed in September 1995 removes the right of IPFs to sit on the boards of companies in which they have shares (although this may be unconstitutional, and therefore rejected by a constitutional court at a later date). All of these measures protect management from organized or institutional shareholder scrutiny, and are intended to reduce the role of IPFs in the exercise of corporate governance in the upcoming years during which many enterprises may be required to restructure. The new proposal also increases the role of the state in the economy by (i) extending full state control over "strategic" enterprises (which include telecommunications, gas and defense industries); and (ii) extending NPF control indefinitely in firms in which it has an equity stake, even when this represents minority ownership.

---

20 This includes the Nafta Gbily, Slovnaft oil refineries and petrol retailing, USZ steel works, Duslo chemicals, and Danubiaprint printing operation.
Box 12: Privatization in the Slovak Republic

Stock of SOEs: SOE figures are inconsistent for reasons of definition and ownership. Total SOEs were 2,388 at end 1993, including all public enterprises at central and municipal government levels, including small retail operations. Estimates show about 550 large SOEs or "strategic" enterprises. GoS has cancelled the second wave of privatization in favor of a bond scheme.

Privatized SOEs: 751 large enterprises and 9,300 small enterprises were privatized as part of the first wave. 184 IPFs control 45 percent of shares from the coupon scheme.

Value of Privatization Transactions: SK 167 billion in book value (US$ 5.6 billion), of which SK 14.5 billion were from direct sales.\(^{209}\) NPF had SK 14 billion in revenues, but paid SK 10 billion by end 1993, of which SK 4 billion was used to recapitalize banks and SK 1.5 billion was used to write off large enterprise debts prior to privatization.

Types of Transactions (First Wave): (i) Coupon scheme: 2.6 million registered for coupons; and (ii) direct sales: one-third of companies sold directly via sales, cash auctions, and public tenders. Direct sales were often for smaller companies than those privatized through vouchers.

Sector Distribution of Privatized SOEs: Most privatized enterprises were small shops and in other services. Among the larger firms, building and engineering (178), food processing (61) and design activity (49) were most prominent. In terms of book value, the largest sectors were in non-ferrous metallurgy (SK 6.3 billion), iron and steel (SK 5.7 billion), banking (SK 4.0 billion), fuel (SK 3.7 billion), and chemicals and rubber (SK 2.3 billion).


3. The Remaining State Sector

The Visegrad countries still have sizeable assets held by the state. While the Czech Republic has privatized extensively, some of the larger "private" enterprises have partial state ownership. About 20 percent of "assets" are still held by the Czech public sector in the form of about 200 SOEs or joint-stock companies. The public sectors of Hungary, Poland and Slovakia still hold about half of total assets. Poland, in particular, has a large number of SOEs. In some cases (infrastructure companies), state enterprises have significant value, and should provide additional proceeds to state treasuries. In many other cases, SOEs are uncompetitive, in dire need of restructuring, and likely to fail. Box 13 profiles the remaining stock of SOEs in the Visegrad countries.

\(^{209}\) Direct sales: SK 14.5 billion, of which 59 percent were from domestic investors who paid five percent less than book value, and 41 percent from foreign investors who generally paid two times book value for better firms.
**Box 13: The Remaining SOE Sector in the Visegrad Countries**

<table>
<thead>
<tr>
<th>Czech Republic</th>
<th>Hungary</th>
<th>Poland</th>
<th>Slovak Republic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remaining SOEs</td>
<td>About 200 SOEs</td>
<td>740 SOEs</td>
<td>5,268 SOEs</td>
</tr>
<tr>
<td>Share of Assets</td>
<td>20%</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>Estimated SOE Losses</td>
<td>Pre-tax profits of 4% of GDP in 1993</td>
<td>Gross losses were 10% of 1993 GDP and 7.5% of 1994 GDP</td>
<td>Losses approximate 2% of GDP</td>
</tr>
<tr>
<td>Sector Distribution of Retained SOEs</td>
<td>Oil and gas, communications, banking, insurance, electricity, airlines, railways</td>
<td>Oil and gas, power, communications, iron, steel, chemicals, banking, pharmaceuticals, fertilizers, chemicals, machine-building, rubber, airlines, railways</td>
<td>Energy, communications, heavy industry (steel, defence), mining, state farms, banking, insurance, airlines, railways, tobacco</td>
</tr>
<tr>
<td>SOE Employment</td>
<td>1.6 million, or 35% of total (including government)</td>
<td>About 800,000 in 1993, or 18%</td>
<td>About 3.3 million, or 40% of total (including government)</td>
</tr>
</tbody>
</table>

Sources: Statistical Yearbook of the Czech Republic (1994); 'Slovakia: Restructuring for Recovery', World Bank, 1994; 'Hungary: Private Sector Assessment', World Bank, 1995; Ministry of Privatization (Poland); internal World Bank reports; Business Central Europe; Oxford Analytica.

**Czech Republic**

With the conclusion of the second wave of privatization, the state still has investments in about 200 SOEs. These include (i) 30-45 percent ownership stakes in four banks accounting for 70 percent of banking system assets; (ii) majority ownership of CSP, the Czech Republic's largest insurance company with 90 percent market share (life and non-life); (iii) 81 percent of CSA, the national airline; (iv) 51-67 percent stakes in several metallurgical firms; (v) 50-70 percent stakes in various mines; (vi) majority shares in oil and gas pipelines; and (vii) majority ownership in SPT, the telecommunications monopoly. Equity capital in the state sector was K 338 billion (US$ 11 billion) at end 1994. This was about 20 percent of reported equity among non-financial enterprises and corporations with at least 25 employees at the time. The government decided that about K 68 billion (US$ 2 billion) in assets (including the partly privatized Czech Airline, CSA) should be retained permanently by the National Property Fund as "strategic" assets. An additional K 127 billion (US$ 4 billion) in GoC shares in banks, CEZ (power company), metallurgical firms and mines are to be held indefinitely by the National Property Fund. Thus, continued state control in the economy will continue in these sectors for the foreseeable future.

GoC plans to privatize remaining assets consist of the following: (i) privatize agricultural property through direct sales; (ii) privatize non-hospital health care facilities through direct sales to doctors; and (iii) entertain offers on a range of 70 enterprises valued at K 20 billion (US$ 0.7 billion). Significant

---

210 About 50 large hospitals are being temporarily retained until the health insurance stabilizes and there is clarification of future financing in the health sphere.
transactions in 1995 have included 27 percent privatization of SPT, the state telecommunications monopoly, and 49 percent of two oil refineries.

**Hungary**

As of mid-1995, Hungary still had 740 SOEs held by state agencies with equity valued by GoH at HUF 1,516 billion (about US$ 11 billion). The state had majority holdings in 441 enterprises, and minority holdings in an additional 299 enterprises. Among the majority holdings, 24 were in "strategic" infrastructure enterprises in which state equity is valued at HUF 1,007 billion (two-thirds of remaining state sector). These consist of telecommunications (MATAV), electricity (MVM), power distribution, power generation, oil (MOL), gas distribution, and broadcasting. Most of the remaining assets in state hands are banks, insurance companies, and often troubled industrial companies (steel mills, chemicals, pharmaceuticals, mining and iron). These have a total book value of HUF 1,103 billion, of which HUF 509 billion (about US$ 4 billion) is held by the state.

After the last elections, GOH went on record with plans to accelerate privatization and divest the bulk of remaining state assets within a three-year period. To that end, Hungary passed a new Privatization Law in May 1995 merging the State Privatization Agency (AVU) and State Property Agency (AVRt) into the State Privatization and Property Management Agency (APVRt), which will be responsible for all non-bank privatization transactions. The state will retain an estimated HUF 255 billion (about US$ 2 billion) in equity, mostly in MVM, MATAV, MOL and MAV to allow it to retain (partial) control of the nuclear plant, power grid, railways, and oil processing. Otherwise, APVRt is expected to fully divest all state equity in 13 power distribution and generation enterprises, five gas distribution companies, all minority holdings in 299 enterprises, and virtually all majority holdings in all other enterprises.

Privatization methods to be used are (i) two rounds of auctions for SMEs in which APVRt has a majority stake (254 enterprises with 103,000 employees; state equity of HUF 30 billion); (ii) public tenders for large-scale enterprises in which APVRt has a majority stake (about 160 enterprises with about 163,000 employees; state equity of HUF 150 billion); and (iii) direct sales to current majority owners, managers and employees, followed by public offerings for all enterprises in which the state holds a minority share (299 enterprises with 100,000 employees; state equity of HUF 329 billion). The remaining state sector in Hungary is highlighted below in Box 14.

---

211 A bid led by PTT Telecom Netherlands and Swiss Telecom won rights to 27 percent ownership in SPT for US$ 1.45 billion. In 1995, the Czech Republic had 400,000 applicants for phone links faced with a 2.5-year wait.

212 An international oil consortium involving Royal Dutch Shell (Netherlands), Agip (Italy) and Conoco (US) will acquire the Chempetrol Litvinov and Kaucuk Kralupy refineries, which need US$ 900 million to modernize. This investment is critical for the transshipment of oil products across Europe, and to reduce Czech dependence on Russian oil supplies.

213 Bank and other financial sector privatizations will still be handled by the Ministry of Finance.

214 Only about HUF 50 billion (less than US$ 350 million) is to be retained by the state in other large enterprises.
Box 14: The State Sector of Hungary

Retained SOEs: 1993 book values of SOEs approximated HUF 1,500-1,943 billion (US$ 15-20 billion). Since 1992, equity and fixed asset values have been revalued to be inflation-adjusted, representing book values that are likely to be significantly discounted during privatization negotiations. The number of SOEs has declined steadily, from 2,100 in 1990 to 1,000 in 1993. AVU and AVRt had 823 enterprises in the state equity portfolio at end 1994. 740 SOEs remain in 1995, with GoH equity of HUF 1,516 billion (US$ 11 billion). GoH plans to divest 80 percent by 1997. 740 SOEs remain in 1995.

SOE Value-Added and Profits/(Losses): SOE value-added contribution to GDP:
- 23.8% in 1990
- 20.8% in 1991
- 20.0% in 1992
- 21.3% in 1993

Gross SOE Losses:
- 2.6% of 1990 GDP
- 8.4% of 1991 GDP
- 14.2% of 1992 GDP
- 10.1% of 1993 GDP
- Estimated to be 7.5% of 1994 GDP

Sector Distribution of Major Retained SOEs: Power, oil and gas, telecommunications, transport, banking, chemicals, fertilizers, iron, steel, electronics, machine building, ball bearings, chemicals, rubber and pharmaceuticals.

SOE and Public Sector Employment: SOE employment in thousands: from 1,019 in 1990 to 612-793 in 1993. The 1993 range is difficult to assess because of joint ventures, spin-offs, and new companies that have been formed.

Sources: "Hungary: Private Sector Assessment", World Bank, 1995; internal World Bank reports.

Poland

At mid-1995, Poland had about 5,000 state enterprises, by far the largest number of state enterprises among the Visegrad countries. Estimated book asset values for state enterprise were US$ 30 billion. For the time being, GoP is retaining partial or total ownership of most state enterprises (SOEs or commercialized companies) for what appear to be a series of reasons: (i) most enterprises are in poor condition, have weak management, and cannot be sold; (ii) significant political opposition exists to privatization; (iii) most domestic investors have bypassed state enterprises, and started up their own companies; and (iv) most foreign investors have found better companies to buy and more accommodating markets elsewhere. State sector share is estimated to be about 50 percent of industry (tobacco processing, mining, oil and gas, steel, chemicals, defense), 60 percent of transport (airlines, urban transport), 75-80 percent of finance (banking, insurance), and nearly 100 percent of telecommunications.

In most cases, GoP policy is to allow case-by-case privatization. There has been some recent privatization movement (after a four-year delay) with the launching of mass privatization, although these companies only account for about 10 percent of remaining SOEs and 12 percent of book-valued assets. However, privatization policy in Poland generally remains passive, resulting in the retention of most state assets by GoP. On the one hand, some movement has been demonstrated with the initiation of mass privatization. There has been some recent movement (after a four-year delay) with the launching of mass privatization, although these companies only account for about 10 percent of remaining SOEs and 12 percent of book-valued assets. However, privatization policy in Poland generally remains passive, resulting in the retention of most state assets by GoP. On the one hand, some movement has been demonstrated with the initiation of mass privatization.

---

Mass privatization included a first tranche of 413 companies, with assets estimated to be US$ 2.8 billion (US$ 6-7 million per company). An additional 101 companies were recently added to the mass privatization program, bringing total assets up to an estimated US$ 3.5 billion, or 12 percent of the estimated book value of total state enterprise assets.
privatization of about 500 SOEs. On the other hand, about 4,500 additional SOEs remain to be reorganized, liquidated or privatized with no organized blueprint for change. Negotiations are ongoing for a number of enterprises, including strategies for partial privatization in many key sectors (tobacco, copper mining, airlines, banking). Nevertheless, unlike Hungary's recently articulated efforts to accelerate the privatization of most state enterprises, or the Czech Republic's organized approach from 1991-1995, the Polish privatization program continues to experience delays.

If a modified version of the recently archived legislation on commercialization and privatization is later adopted, there is a possibility that the state will further delay privatization and opt for a longer-term commercialization approach. If this occurs, 3,000-4,000 SOEs could be commercialized without specified objectives, methods or timetables for privatization. This could (i) perpetuate state ownership in critical sectors of the economy; (ii) increase the public sector's role in the corporate governance of many of these enterprises; and (iii) possibly lead to the formation of holding companies to consolidate (and possibly protect) troubled industrial sectors (coal, steel). Even without industrial protection, delays in privatization are almost certain to continue. One reason is that parliamentary approval has been proposed for privatization transactions in "strategic" sectors. Commercializing most enterprises would require Council of Ministers approval, which would delay even this stage of the process. Thus, while commercialization legislation has been rejected for the time being, it also appears that recent political developments provide GoP with an opportunity to retain significant influence in the economy by virtue of its retention of state assets (see Section IV). The remaining state sector in Poland is highlighted below in Box 15.

Box 15: The State Sector of Poland

Retained SOEs: State still has 5,268 SOEs (including 514 commercialized enterprises being mass privatized). About half of all these SOEs are loss-makers. Among the approximately 2,500 loss-makers, 1,400 have already started to privatize or liquidate. Book values of remaining SOEs are estimated to be US$ 23.5-30 billion by the Ministry of Privatization.

SOE Profits/Losses: Losses of 2.4% GDP (1992) and 1.9% GDP (1993).

Sector Distribution of Retained SOEs: Banking, insurance, mining, energy, steel, telecommunications, airlines, tobacco and defense. Some are too weak to sell, but too big to close without causing major unemployment. Many of these enterprises will eventually fail, showing not-so-early warning signs such as rising tax arrears and inter-enterprise debts. The state still controls fuel, energy and public transport prices. Tobacco growers still have a monopoly, although not with tobacco processing (RJ Reynolds and other investors are setting up processing plants).

SOE and Public Sector Employment: 41% of total employment in 1993, down from 43% in 1992. The majority (1993) are found in industry, forestry, transport, communication, community services, and "non-material production" (including finance and insurance). Privatized and joint-venture SOEs have transferred about two-thirds of the original SOE work force to the private sector.

Sources: Central Statistical Office (GUS); Ministry of Privatization; internal World Bank reports; Oxford Analytica.

Slovak Republic

Despite the successes of the first wave, the largest owner of state property remains the National Property Fund (NPF), a government trustee which administers privatization transactions and "supervises" about one-fifth of companies in its portfolio. By September 1993, NPF owned majority stakes in 101 enterprises, and minority stakes in 456 enterprises. These assets were valued at SK 135 billion (US$ 4.5 billion), of which the NPF share was about one-third. The state also retains direct ownership of firms in the defense, power generation, banking, insurance, telecommunications and oil and gas sectors. NPF
sits on the board of about 120 companies, mostly as a passive investor even when it is the majority shareholder. The other firms are under private ownership and control.

Since end 1993, little has occurred regarding privatization, and questions remain concerning ongoing reversals, political stagnation, and privatization methodology. Some "strategic" enterprises such as ZTS Dubnica (military), Slovak Telecom (telecommunications), SEP (power generation), SSE, VEZ Kosice and VEZ Bratislava (power distribution), SPP (gas), and VAK Bratislava, VAK Kosice and ZSL Bratislava (water distribution) are being retained indefinitely, a reversal of the earlier decision to review prospective transactions on a case-by-case basis. The state expects to retain ownership and control through NPF equivalent to about 40-45 percent of second wave privatization values (see "C2. Country Reviews of Enterprise Privatization"). Thus, recent decisions indicate GoS intentions to retain larger portions of and exercise greater control over the industrial sector than originally decreed. A profile of the remaining state sector is shown in Box 16.

---

**Box 16: The State Sector of the Slovak Republic**

_**Retained SOEs:** At end 1993, there were 2,388 public enterprises (including municipally owned). Total book value of NPF enterprises was SK 136 billion, of which NPF shares were valued at SK 48 billion (about US$ 1.6 billion).

_**SOE Profits/Losses:** Losses were estimated at 5% of 1993 GDP.

_**Sector Distribution of Retained SOEs:** The state owned 74.4% of industry in 1993. Most publicly-owned enterprises were in banking, insurance, manufacturing, construction, "commercial and services", agriculture, forestry and fisheries. NPF stakes include ownership in some of Slovakia's largest companies: VUB bank (51%); Slovak Insurance (52%); Slovnaft oil (80%); Benzinol oil distribution (97%); Nafta gas (55%); Trnavske auto (50%); Zavod SNP aluminum (72%); and Slovakofarma chemicals (81%).

_**SOE and Public Sector Employment:** SOE employment has declined with the increase in private sector firms and self-employed. Public enterprise employment declined from 1.2 million in 1990 to 620,000 in 1993. Total state employment declined from 1.8 million in 1990 to 0.9 million in 1993.


---

216 To demonstrate the privatization stagnation that set in around 1993, NPF owned all or part of 533 companies with book values of SK 153 billion (US$ 5 billion) at end 1992. Hence, NPF's portfolio of enterprises increased by a net 24 enterprises in 1993, although book values were slightly lower. Once transferred to NPF, the enterprises have not moved. Thus, while the state has transferred properties to NPF, NPF has failed to transfer properties to the private sector. When it has, it has often done so on a political basis.

217 Slovnaft re-acquired Benzinol in 1995.
IV. COMPARATIVE ASSESSMENT OF PRIVATE SECTOR DEVELOPMENT

A. Introduction

Having looked at privatization (of the old stock of assets), this section attempts to look at general private sector development with a focus on new business investment, development and trends. One of the clearest trends evident in the region is the emergence of new businesses, often self-employed or small-scale and in the service sector, generating far higher margins than the state-owned sector. This trend is pervasive throughout transition countries, as ordinary citizens of limited means have acquired or invested in small enterprises and responded to the service sector void left by central planning. The biggest shifts in the Visegrad countries have been (i) the decline in industry in the Czech and Slovak Republics and the growth of the service sector as a percentage of GDP; and (ii) the decline in agriculture in Hungary and Poland (see Table 4). As in other transition economies, what has also changed is the ownership composition away from state enterprises and increasingly to the private sector, although less in the industrial sector than in agriculture and services.

In the Visegrad countries, as elsewhere, the emergence of this new private sector has resulted from (i) small-scale investments in new businesses; (ii) enterprise privatization (via mass privatization, public auctions, management/employee buyouts); and (iii) the general policy embrace of market economics. Despite incomplete conversion from state ownership and control to a fully liberalized market, the Visegrad countries have experienced significant private sector growth across sectors. Table 5 highlights the rate of private sector growth as a percentage of total GDP and employment between 1989-1994 in the Visegrad countries.

In most cases (apart from the Czech Republic), privatization programs have lagged overall private sector development. While all four countries have privatized a significant number of enterprises—about half in Hungary and Poland, and more than three quarters in the Czech and Slovak Republics—Hungary, Poland and Slovakia have been reluctant to part with some of the largest industrial enterprises. For this reason, as a percentage of assets, only the Czech Republic has privatized more than 75

<table>
<thead>
<tr>
<th>Table 4: Sector Shares of GDP in the Visegrad Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
</tr>
<tr>
<td>Czech Republic</td>
</tr>
<tr>
<td>Hungary</td>
</tr>
<tr>
<td>Poland</td>
</tr>
<tr>
<td>Slovak Republic</td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th>Table 5: Private Sector Growth in the Visegrad Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Sector Employment</td>
</tr>
<tr>
<td>Czech Republic</td>
</tr>
<tr>
<td>Hungary</td>
</tr>
<tr>
<td>Poland</td>
</tr>
<tr>
<td>Slovak Republic</td>
</tr>
</tbody>
</table>

Sources: Central Statistical Offices of all four countries; internal World Bank reports.
percent of formerly state-owned assets. In the other Visegrad countries, the range has been about half.\textsuperscript{218} State ownership in the industrial and financial sectors generally remains high, while private ownership is more predominant in small- and medium-scale businesses, usually active in light manufacturing and the service sector.

B. Enterprises: Private Sector Trends By Sector and Country

1. Summary

The Visegrad countries have experienced a significant increase in the role of the private sector since reforms began. In both GDP and employment, the private sector has shown steady growth each year. Part of this is from privatization, particularly in the Czech Republic (see Section III). Yet much of the private sector growth is coming from new start-up enterprises with no links to the earlier tenets of central planning. Particularly in Hungary and Poland, it is from here that much of the private sector growth, employment and investment is derived.

2. Czech Republic

The Czech Republic has been successful at stimulating private sector development, largely due to rapid privatization of its state sector. Since 1989, the private sector share of GDP and employment have grown to nearly two-thirds of total.\textsuperscript{219} Much of the growth has come from the service sector, which today accounts for more than half of total output. This has been accompanied by significant increases in the allocation of credit to the private sector, and emergence of capital markets which have played a critical role in the Czech Republic’s rapid privatization.

Private Sector Contribution to GDP

Private sector contribution in the Czech Republic has increased from 4 percent of 1989 GDP to about 56 percent in 1994. On a sector basis, industry has declined steadily from 56 percent of GDP in 1990 to 40 percent in 1993 (see Table 4). However, significant restructuring is taking place as private sector

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|c|}
\hline
\hline
GDP & 4\% & 11.5\% & 16\% & 25\% & 44\% & 56\% \\
Employment & 16\% & 20\% & 30\% & 40\% & 59\% & 65\% \\
Consumption & NA & 72\% & 70\% & 72\% & 71\% & 72\% \\
Credit & NA & 16\% & 16\% & 34\% & 56\% & 62\% \\
\hline
\end{tabular}
\caption{Private Sector Shares/Trends in the Czech Republic}
\end{table}

Sources: Internal World Bank reports; World Bank staff estimates; EBRD.

\textsuperscript{218} These percentages are based on assessments of book values.

\textsuperscript{219} Prior to the Velvet Revolution in 1990, SOEs dominated the enterprise sector. Private entrepreneurs were excluded from most sectors of the economy. Prices, trade and investment were controlled. Private property had little protection. However, the Czech (and Slovak) Republic benefitted from a comparatively strong industrial base, proximity to the industrial market economies of Central and Western Europe, and an early emphasis on rapid privatization during the CSFR phase (see Section III).
sector Czech sub-contractors export to larger EU markets. Thus, while industry has declined as a percentage of GDP, the private sector share has likely increased. Agriculture has shown slight declines, but remains a minor part of the Czech economy. By contrast, services have steadily grown from year to year, from 36 percent in 1990 to 54 percent in 1993. There has been particular growth in the construction sector, although transport and industry are also showing increasing private sector contribution to GDP. While statistics may not be wholly accurate, it appears that private sector shares are about 57 percent of total industry, 90 percent of construction, and more than half of transport. The informal sector is also estimated to be about 12 percent of GDP, low by Visegrad standards and about double the estimated OECD average.

Given these general trends, the small-scale and owner-operated private sector appears to be growing while large-scale SOEs in the industrial sector are contributing proportionally less to GDP. The Czech Republic has seen self-employed enterprises increase from 20,000 in 1989 to 640,000 in 1993, of which two-thirds are sole proprietors. The other one-third of these enterprises likely accounts for employment of at least 20-25 percent of the total work force, and as in the other Visegrad countries (particularly Hungary and Poland) likely accounts for a disproportionate share of GDP and export growth. Unlike in Hungary and Poland, lending to enterprises and households have increased, although general investment as a percentage of GDP was flat in 1993-1994. The favorable lending trends are made possible by a relatively stable macroeconomic environment characterized by comparatively low inflation and interest rates and relative fiscal balance.

Private Sector Employment and General Unemployment

Private sector employment has increased from 16 percent in 1989 to 65 percent in 1994, much of it generated by owner-operated and small-scale light manufacturing and service sector businesses. The shift has also been due to significant employment reductions in the industrial sector, reflecting some active restructuring in this sector. The split with the Slovak Republic helped the Czech Republic release many of the uncompetitive, heavy industrial enterprises of the CSFR. From 1989-1993, manufacturing employment declined 19 percent, and mining employment declined 32 percent. Most of these were SOEs. Between the split with the Slovak Republic and the general decline in the state industrial sector, average employment at Czech industrial enterprises declined significantly, from 1,665 in 1990 to 360 in 1994. Employment in the agricultural sector also declined 38 percent, much of it from state farms. By contrast, employment in commercial trade increased 9 percent, and financial services increased from a small base by 156 percent (much of it in insurance and Investment Funds). Not all employment growth was in the private sector, as employment in public administration increased 176 percent, resulting largely from the increase in self-employed enterprises.

Average annual CSFR exports to the EU increased 24 percent between 1989-1993 to ECU 6 billion, with market share more than doubling from .56 percent to 1.23 percent. This coincided with a sluggish economic period in the EU. Since 1993, the economy has picked up, as have Visegrad exports. The Czech Republic has benefitted significantly from this growth, largely on the basis of sub-contracting arrangements. Major export growth products are fixed electrical capacitators, unwrought tantalum, leather uppers, motor parts and accessories, motor cars, articles of iron and steel, mixtures of ammonium nitrate, machinery and appliances, mens' footwear and outer soles, and electrical energy. See B. Hoekman and G. Pohl, "Enterprise Restructuring in Eastern Europe", World Bank, March 1995.

One third of 640,000 = 213,333. The total work force approximates 5.4 million. Therefore, 20 percent of 5.4 million = 1.08 million, or about five employees per firm.
from the spinning off of non-core assets by ex-SOEs that provided for social needs (day care, health care).

Meanwhile, unemployment rates have been among the lowest in the world, at 4.1 percent, 2.6 percent, 3.5 percent and 3.2, respectively, from 1991-1994. Thus, with a working population approximating 5.4 million, unemployment has ranged from 134,800 (1992) to 221,700 (1991). Low unemployment rates have partly derived from the voluntarily departure of more than 500,000 from the labor force, often women with children who have taken early retirement. As in other transition countries, the reduction in Czech labor force participation is linked to the changing role of enterprises in providing social services, which have largely been spun off through privatization. Other reasons for low unemployment have been the low cost of labor due to a weak (undervalued) currency, modest unemployment benefits, and difficulties associated with releasing employees due to protective labor laws and practices (see Section II). There is significant risk that unemployment rates will increase in the future because of the continued restructuring needs of many privatized companies if they are to increase labor productivity and be competitive in the European marketplace.

Private Sector Credit

Credit to the private sector has increased from about 16 percent of total credit in 1991 to about 62 percent of total credit in 1994, or about a 5-6 times increase from US$ 3.0 billion in 1991 to US$ 16.6 billion in 1994. In GDP terms, credit to the private sector has increased from 13 percent in 1991 GDP to 50 percent in 1994. This represents a significant departure from trends in Hungary and Poland, where banks have shifted their resources increasingly to government securities to take advantage of broad net spreads between deposit rates and yields on marketable securities. Lending has steadily increased from commercial banks to private households, individuals and non-profit institutions. These shares reflect the aggressive enterprise privatization efforts of the Czech government, as well as the effective privatization of bank lending stocks and flows after the up-front carve-out and recapitalization of SOCBs before their privatization. By economic sector, most loans are still to manufacturers and commercial traders, with most other sector lending relatively flat (agriculture, mining, power) or showing slight increases (construction, transport). Average lending rates were negative in real terms from 1991-1993, and then turned slightly positive in 1994.

---

222 In 1993, 71 percent of males and 57 percent of females more than 15 years old were working or seeking work.

223 The unemployed receive (i) 60 percent of their former salary during the first six months; (ii) 50 percent during the second six months; and (iii) KC 2,300 per month (about US$ 80, or one-third of annualized per capita incomes) on a means-tested basis and tied to public works thereafter.

224 Czech companies are reported to use three times as much labor, and 10 percent more raw materials, energy and services than EU companies producing comparable goods. Combined with outdated equipment which will be costly to replace, Czech goods are now competitive largely because of low wages and the undervalued Koruna (crown). Once the currency appreciates, it is likely that new investments in fixed assets will be required to enhance competitiveness. It is also likely that reductions in the number of employees will be needed to reduce the disparity between Czech and EU levels, particularly if there are real wage increases.
Table 7: Lending Patterns in the Czech Republic

<table>
<thead>
<tr>
<th>Year</th>
<th>US$mil</th>
<th>%</th>
<th>US$mil</th>
<th>%</th>
<th>US$mil</th>
<th>%</th>
<th>US$mil</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>18,853</td>
<td>100.0</td>
<td>21,759</td>
<td>100.0</td>
<td>23,823</td>
<td>100.0</td>
<td>28,621</td>
<td>100.0</td>
</tr>
<tr>
<td>1992</td>
<td>1,032</td>
<td>5.5</td>
<td>1,738</td>
<td>8.0</td>
<td>1,413</td>
<td>5.9</td>
<td>1,085</td>
<td>3.8</td>
</tr>
<tr>
<td>1993</td>
<td>17,820</td>
<td>94.5</td>
<td>20,021</td>
<td>92.0</td>
<td>22,410</td>
<td>94.1</td>
<td>27,535</td>
<td>96.2</td>
</tr>
<tr>
<td>1994</td>
<td>1,755</td>
<td>9.3</td>
<td>5,765</td>
<td>26.5</td>
<td>11,687</td>
<td>49.1</td>
<td>15,972</td>
<td>55.8</td>
</tr>
</tbody>
</table>

Sources: Czech National Bank; internal World Bank reports; World Bank staff estimates.

Despite favorable economic indicators and the active restructuring of many SOEs and privatized companies, a potentially large number of privatized companies are technically insolvent (and practically illiquid). Inter-enterprise arrears are estimated at K 150400 billion (US$ 5.3-14.3 billion), or 14-39 percent of 1994 GDP. This could impair bank loan portfolios and IPF net asset values if enterprises face increasing liquidity constraints. Consequently, the enterprise sector could face a decline in lending and equity investment. While the best large-scale performers are now able to attract loans from foreign banks and remain good investments for IPFs, the large domestic SOCBs are worried about losing this blue chip business which has been used to cross-subsidize losses at less competitive industrial enterprises. If the large state banks lose this business, their portfolios will deteriorate, which could prompt IPF sell-offs. Banks, with increasing recognition of non-performing loans, may choose to allocate resources to less risky areas of the economy (government securities) to recapitalize their balance sheets, as troubled banks have done in Hungary and Poland.

Private Sector Deposits

Total deposits in 1994 were US$ 27.4 billion, with GoC and state organizations accounting for US$ 8.5 billion (31 percent) of these. Therefore, the private sector share of deposits is about 69 percent, showing little change since 1991. While the private sector is a net lender to the banking system, the disparity between private sector shares of deposits and credit was only 7 percent in 1994, far less than in Hungary and Poland where household deposits generally finance government borrowings. Deposits have steadily increased since 1991, with a slow but steady increase in the proportion of time deposits (from 50 percent to 55 percent) between 1991-1994. Average deposit rates on 6-month accounts have been about 8-11 percent during this period. The inflation rate has ranged from 10 percent (1990) to 57 percent (1991), and was 10 percent in 1994. Hence, real rates on deposits were highly negative in 1991, and have subsequently fluctuated between negative 11.2 percent (1993) and negative 0.5 percent (1994).
Table 8: Deposit Patterns in the Czech Republic

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>US$ mil</td>
<td>%</td>
<td>US$ mil</td>
<td>%</td>
</tr>
<tr>
<td>Total Deposits</td>
<td>13,852</td>
<td>100.0</td>
<td>17,913</td>
<td>100.0</td>
</tr>
<tr>
<td>o/w Public/SOE</td>
<td>3,954</td>
<td>28.5</td>
<td>4,163</td>
<td>23.2</td>
</tr>
<tr>
<td>o/w Private Enterprises</td>
<td>2,286</td>
<td>16.5</td>
<td>4,747</td>
<td>26.5</td>
</tr>
<tr>
<td>o/w Priv. Households</td>
<td>7,613</td>
<td>55.0</td>
<td>9,003</td>
<td>50.3</td>
</tr>
<tr>
<td>Average Inflation Rate</td>
<td>56.6%</td>
<td>11.1%</td>
<td>20.8%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Real Interest Rate*</td>
<td>-46.1%</td>
<td>-2.9%</td>
<td>-11.2%</td>
<td>-0.5%</td>
</tr>
</tbody>
</table>

* On six-month deposits

Sources: Czech National Bank; World Bank staff estimates.

Private Sector and Foreign Investment

Fixed investment as a percentage of GDP has declined in the Czech Republic, from 27-29 percent in 1989-1990 to less than 20 percent in 1993-1994. On a US dollar basis, fixed investment has declined from an annual US$ 9.2 billion in 1989-1990 to an average annual US$ 6.6 billion from 1993-1994. It is uncertain how much of the investment has come from the private sector, although it is likely that the decline in investment is mainly in the state sector. Offsetting some of the decline in domestic investment has been the Czech Republic’s strong FDI performance since 1991 which (i) has approximated US$ 3 billion, or 2.5 percent of 1991-1994 GDP; and (ii) compensated for some of the decline in domestic investment. This success is particularly noteworthy considering FDI was only US$ 133 million in 1990, rising to US$ 1 billion each year in 1992 and 1993. As a share of GDP, FDI has increased from practically zero in 1990-1991 to 2.5 percent, 3.5 percent, and 3.4 percent, respectively, from 1991-1993. FDI fell to US$ 525 million (1.5 percent of GDP) in 1994, a 52 percent decline as many of the most attractive firms were privatized during the first wave (which ended in 1993). Despite the 1994 fall, FDI is expected to rebound significantly in 1995 and thereafter due to the partial privatization of blue chip enterprises in the telecommunications, oil and gas, and other infrastructure sectors (see Sections II and III). Compared to other Visegrad states, FDI in the Czech Republic has been twice that in Poland (1991-1994), and about eight times on a per capita basis. However, more can be done when compared with Hungary, whose FDI was double that of the Czech Republic from 1991-1993 despite (i) having about the same population and GDP; and (ii) not pursuing privatization as actively as the Czech Republic. Lowering tax rates, increasing labor productivity, and easing some of the infrastructure problems faced by businesses (telecommunications, property rentals) would facilitate FDI.
Private Sector Share of International Trade

The Czech Republic's level of trade in goods and services has increased significantly since 1992, with a surge of trade in both merchandise and services.\(^{225}\) Total trade values (goods and services) increased from an average annual US$ 24.4 billion in 1990-1991 (87 percent of GDP) to an average annual US$ 35.8 billion in 1992-1994 (113 percent of GDP). Much of this growth came from increases in non-factor service receipts, with the Czech Republic registering large surpluses due to increased trade and tourism, and low debt service. Non-factor service receipts have shown surpluses of US$ 3.4 billion since 1992, increasing to one-third of (steadily growing) export earnings from about 4 percent from 1989-1991. What is unclear is the private sector share of international trade. A reasonable estimate is to correlate the private sector share of GDP (56 percent in 1994) with trade, which would translate into nearly US$ 22 billion in private international trade in 1994, compared to less than US$ 4 billion in 1991. What is clear is that the Czech economy has become more competitive in international services, and the private sector is responsible for this change. This is also true with the growth of industrial subcontractors exporting to West European markets. However, there are concerns about Czech competitiveness\(^{226}\) in the merchandise sector, particularly as the merchandise trade deficit is expected to increase in 1995.\(^{227}\)

Despite competitive challenges in the merchandise trade sector, improvements in Czech competitiveness have shown themselves in the redirection of trade almost immediately after the dissolution of Czechoslovakia (as well as in increasing per capita value-added to imported raw materials). In 1989, trade with the former centrally planned economies accounted for nearly half of imports and exports, while trade with the European Community approximated 30 percent. By 1994, Czech exports to EU countries were 57 percent of total, and imports were 51 percent of total. Thus, as with the other Visegrad countries, the Czech Republic has increasingly emphasized EU markets in its international trade patterns since the CSFR period.

3. Hungary

The private sector is responsible for an increasing share of GDP in Hungary, from 20 percent in 1989-1990 to at least 60 percent in 1994. This translates into a nearly fourfold increase in private sector contribution to GDP in six years.\(^{228}\) Employment trends have followed the same course, although precise data are not available. Most of this growth has come from "new" investment and enterprises, as

---

\(^{225}\) The total merchandise trade deficit during this period was US$ 3.0 billion, reflecting extensive purchases of goods from abroad, particularly in 1992. However, trade in services from 1992-1994 shows a surplus of US$ 3.4 billion, also mostly in 1992.

\(^{226}\) Czech industry added US$ 790 per capita to imported raw materials in 1993, and US$ 901 per capita in 1994. This compares with 1993 value-added in Switzerland (US$ 8,254), Germany (US$ 3,548), UK (US$ 2,289), and several other smaller West European countries (Austria, Netherlands, Sweden) with an average of US$ 5,342 per capita.

\(^{227}\) The merchandise trade deficit is expected to exceed US$ 3 billion in 1995, which equals the total merchandise trade deficit from 1992-1994.

\(^{228}\) 1989 GDP approximated US$ 30 billion, of which private sector GDP was about US$ 6 billion. In 1994, GDP approximated US$ 40 billion, of which private sector GDP was about US$ 24 billion.
opposed to privatization (see Section III). Fixed investment has increased to nearly 22 percent of GDP, after dropping to as low as 15 percent in 1992, and then recovering since 1993. Increased investment has come from (i) new private enterprises, which account for two-thirds of total investment in fixed assets; and (ii) foreign investment, which has increased considerably since 1991 (see Table 14). Nevertheless, due to Hungary's weak fiscal position and high level of indebtedness (see Table 12), GoH borrowings have partly relied on the domestic commercial banking system for deficit financing (see "Private Sector Credit and Inter-Enterprise Arrears" below). Consequently, GoH borrowings have crowded out bank lending to private sector enterprises, households and small businesses (although FDI has provided larger Hungarian enterprises with needed investment). Over the coming years, greater contribution from the private sector to GDP is projected with the eventual privatization of large SOEs (see Section III). Major problems confronting private sector expansion are (i) high payroll tax rates (40-50 percent); (ii) the lack of bank credit, particularly long-term credit; and (iii) insufficient investment, largely due to (i) and (ii). Nevertheless, Table 9 shows the private sector has shown increasing strength in the Hungarian economy since the late 1980s.

Private Sector Contribution to GDP

The private sector contributes approximately 60 percent of total GDP in Hungary, an increase from 20 percent in 1989-1990. Nearly three-quarters of GDP are generated by "non-material" services (including financial, legal, consulting, tourism), industry and trade, most of which is private. Major sectoral trends on a GDP basis in recent years have been as follows: (i) industry, construction, and agriculture/forestry have declined steadily since 1989; (ii) transport and communications, trade and customs have fluctuated or shown little change between 1989 and 1993; and (iii) non-material services have nearly doubled, making it the clear winner among sub-sectors. Among formally registered firms, there has been a shift in the sectoral mix of firms increasingly to trade and services, with the number of infrastructure firms slightly up and manufacturing firms down.229 As in the other Visegrad countries, this reflects a structural change in output based on

---

229 The total number of formally registered firms grew by 2.57 times between 1990-1993. Trade and services firms increased 3.35 times, followed by infrastructure (2.63) times and manufacturing (2.40) times.
(i) declining SOE performance in agriculture and heavy industry; and (ii) increasing private sector investment in light manufacturing and services.

The number of registered firms in Hungary has increased more than threefold since 1990, with virtually all of the increase in the private sector (see Table 10). Even more striking has been the increase in self-employed, from 427,500 in 1990 to 801,700 in 1993. This surge is consistent with trends in the Visegrad countries, and combined with growth in the number of larger private enterprises is responsible for a significant and growing part of employment and GDP. These trends show growth of more than 400,000 new private firms since 1990 in a country with 10.3 million people. Most of these firms are very small (less than 20 employees, and often individuals sub-contracting out), and are estimated to have contributed the most to GDP growth. While predominantly service sector in focus, small private enterprises were also responsible for 14.5 percent of industrial output in 1993. It is also estimated that the informal sector share of GDP was as high as 27 percent in 1992 and 30-35 percent in 1993, although value added figures show the contribution is about 16 percent.

Private Sector Employment and General Unemployment

The scale of enterprises has declined from 1990-1993 as SOE performance has declined. Manufacturing employment in formal sector firms has dropped 36 percent during this period, much of it in the state sector. Most growth has come from the privately self-employed and small-scale private sector. Although it is difficult to measure exact figures due to statistical problems, private firms with less than 20 employees and smaller formal firms are responsible for new jobs and growth in the industrial and service sectors.

Table 11 summarizes enterprise, employment and value-added trends in Hungary from 1990-1993. In general, the average Hungarian enterprise today is smaller than in 1990, reflecting considerable restructuring in the formal sector. Formal sector firms generally had an average of 28 employees (minimum of 20 employees), and value added of HUF 26.5 million (US$ 265,000) at end 1993. This compares with an average of 113 employees and HUF 65 million (US$ 1 million) in 1990. Thus, formally registered firms are three times more numerous, but about one-quarter the size of the average formally registered firm in 1990. The informal sector has shown little increase in employment per enterprise, and a decline in value added, from HUF 1 million (US$ 16,000) in 1990 to HUF 680,000 (US$ 6,800) in 1993. Value-added from the private sector is likely understated due to widespread tax avoidance, particularly as it is recognized that this is the source of investment growth and successful export activities in the economy.

---

230 In 1989, there were 412,000 informal enterprises. Thus, rapid change in the number of informal enterprises accelerated after 1990.

231 Total manufacturing employment has declined 27 percent, indicating significant informal sector employment in the manufacturing sector.

232 Statistical problems include: (i) the growth in micro and small enterprises, including those from spin-offs, mergers, and other privatization transactions; (ii) lack of cooperation from private businesses, including larger joint-venture and foreign-owned firms, with the Central Statistical Office and line ministries; (iii) changes in sub-sectoral classification; (iv) cross-ownership, which is not adequately captured by official statistics; and (v) lack of financial information attached to tax returns from firms with less than 20 employees.
Table 11: Firm Size, Value Added and Employment Trends in Hungary

<table>
<thead>
<tr>
<th>No. of Enterprises</th>
<th>HUF Value-Added*</th>
<th>Employment** (000)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1990</td>
<td>1993</td>
</tr>
<tr>
<td>Tot. Formal Sector</td>
<td>27,500</td>
<td>70,700</td>
</tr>
<tr>
<td>Avg. Formal Sector</td>
<td>65,127</td>
<td>26,534</td>
</tr>
<tr>
<td>Tot. Informal Sector</td>
<td>427,500</td>
<td>801,700</td>
</tr>
<tr>
<td>Avg. Inform. Sector</td>
<td>987</td>
<td>679</td>
</tr>
<tr>
<td>Total Enterprises</td>
<td>455,000</td>
<td>872,700</td>
</tr>
<tr>
<td>Avg. Enterprise</td>
<td>4,864</td>
<td>2,773</td>
</tr>
</tbody>
</table>

* Total value-added expressed in billions of HUF. Averages are in HUF thousands; ** These figures vary from other employment figures which show total employment of 5.5 million in 1990 and 4.35 million in 1993.

Sources: Ministry of Finance; internal World Bank reports.

Meanwhile, with manufacturing employment down by 27 percent and declining performance in the agricultural sector, unemployment has risen from 24,200 in 1990 (1.6 percent of total) to a high of 663,000 in 1992 (12.3 percent of total). On a positive note, the number of officially unemployed declined to 632,000 in 1993-1994, translating into an unemployment rate of 10.9 percent in 1994 (about average for EU countries). With high levels of informal employment, Hungary’s real unemployment rate is likely about 7-8 percent, which is comparatively good by European standards. Labor productivity increased 33 percent and 25 percent, respectively, in 1992 and 1993 on a local currency basis. This would be consistent with formal sector data shown in Table 11 above, where value-added per employee increased from HUF 576,345 (about US$ 9,400) in 1990 to HUF 1 million (US$ 10,000) in 1993.

Private Sector Credit

The Hungarian private sector has grown in recent years despite the GoH fiscal deficit and its impact on bank lending, which has provided only limited resources to the Hungarian private sector. Table 12 shows lending trends since 1989, indicating households and small entrepreneurs have received significantly less credit since 1991, from US$ 6.1 billion in 1991 to about US$ 3.3 billion in 1992-1994. Thus, the net decline of nearly US$ 3 billion in bank lending flows has coincided with increasing demand, and covered by remittances as the number of small enterprises has increased more than a third in the last five years. There has also been a decline in credit to the "enterprise" sector, meaning enterprises with at least 20 employees in both the state and private sectors. Demand has increased here as well, as the number of private sector enterprises has increased (see Table 11). Meanwhile, credit to the enterprise sector has declined from a high of US$ 9.7 billion in 1990 to US$...
6.8 billion in 1993 and US$ 7.1 billion in 1994. The decline in lending to the private sector has coincided with significant and steady increases in budget deficits since 1991 (cumulative US$ 8.1 billion), and net increases in credit to Government since 1992 of US$ 7.7 billion.

<table>
<thead>
<tr>
<th>Table 12: Lending, Borrowing and Investment Trends in Hungary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Banking Assets (US$ mil)</td>
</tr>
<tr>
<td>Net Domestic Credit (US$ mil)</td>
</tr>
<tr>
<td>o/w Government, net</td>
</tr>
<tr>
<td>o/w Enterprises</td>
</tr>
<tr>
<td>o/w Households, Small Entrepreneurs</td>
</tr>
<tr>
<td>Total Investment (US$ mil)</td>
</tr>
<tr>
<td>Total External Debt (US$ mil)</td>
</tr>
<tr>
<td>Budget Surplus/(Deficit) (US$ mil)</td>
</tr>
</tbody>
</table>

Sources: National Bank of Hungary; internal World Bank reports.

Aggregate statistics show a clear trend of increased financing of government at the expense of non-governmental sectors. This has resulted in a marginalization of households, small entrepreneurs and formal private enterprises in the provision of credit which, along with high tax rates (see Section II), has probably been the central reason for informal GDP rising as a share of total. Meanwhile, this vicious cycle is further reinforced by the increase in real rates paid by GoH on Treasury bills (from 1 percent in 1992-1993 to 8 percent in 1994), narrowing the real credit-Treasury bill rate gap from 15-16 percent to 5 percent. Meanwhile, inter-enterprise arrears remain at high levels, as are arrears to the GoH and social insurance funds, reducing further the incentive for banks to lend to enterprises.

**Private Sector Deposits**

Total deposits have increased steadily since 1989, rising from US$ 8.4 billion in 1989 to US$ 14.3 billion in 1994. Households became net lenders to the banking system in 1991, a trend which has continued since. As a percentage of total banking system assets, deposits have generally been about 45 percent but rising. Households are the largest depositors, averaging 54 percent of total deposits since 1989. Enterprises accounted for 35 percent of total deposits during the same period, and other accounts approximated 11 percent. From these figures, it is estimated that private sector deposits account for about three-quarters of total deposits. Nominal deposit rates peaked at 30 percent in 1991, and were

---

237 Taking total enterprise credit and total enterprises, the average enterprise loan was US$ 421,000 in 1990. By 1993, this had declined to US$ 95,870. Using 1990 averages, only 16,100 enterprises would have received loans, or 23 percent of total.

238 Real lending rates on credit were 15.5-16.5 percent in 1992-1993, while real rates on Treasury bills were 1 percent for the period for a gap of about 15 percent. Real lending rates declined to 13 percent in 1994, while real Treasury bill rates increased to 8 percent for a gap of 5 percent.

239 It is difficult to determine the position of enterprises, as small enterprises are combined with all enterprises from the deposit side, but combined with households on the lending side. Nevertheless, on an aggregated basis, households and enterprises became net lenders to the banking system in 1992.

240 Deposits were 40 percent of banking system assets in 1989, and 50 percent in 1994.
about 16 percent in 1993 and 20 percent in 1994. On a real basis, deposit rates have been marginally positive (1.5-2.6 percent), and in some cases negative (as in 1993). In general, rates on six-month deposits have been less than annual inflation rates, providing negative real returns. With negative real rates on deposits and limited credit provided by banks to households and small businesses, there is a real risk of financial disintermediation occurring in the SME and microenterprise sectors which could constrain overall private sector growth. Likewise, given the existing incentive structure, there is a risk to the banking sector that households and small businesses will withdraw deposits from banks, raising the risk of banking system instability and reducing a comparatively cheap source of funding for the banks.

Private Sector and Foreign Investment

As discussed in Section III, Hungary has privatized about half of its assets. However, most growth in the economy is coming from new private enterprises, often with fewer than 20 employees. These companies are responsible for two-thirds of new investment in fixed assets. Meanwhile, most investment is coming from the domestic private sector and private international investors.

As has occurred in the Czech Republic, foreign investment has partly offset declines in domestic investment. Total investment in Hungary declined in the early 1990s with a plunge in domestic investment, with part of this decline in 1991-1992 offset by significant increases in FDI. Assisted by a revival of domestic investment, total investment rebounded in 1993-1994 (see Table 14). As a share of GDP, domestic investment declined from 26 percent in 1989 to an average 13-14 percent in 1991-1993 and 18 percent in 1994. From 1991-1994, foreign investment accounted for nearly one quarter of total investment in Hungary, and is comparatively high by international standards. Were it not for the significant increase in FDI in 1993, Hungary would have needed approximately US$ 3 billion in additional financing, or about 8 percent of GDP.\textsuperscript{241} With a slowdown in privatization and a worsening of macroeconomic fundamentals (fiscal deficits, real wage increases), 1994 foreign investment levels declined to 1991-1992 levels.

\begin{table}[h]
\centering
\begin{tabular}{|l|c|c|c|c|c|c|}
\hline
\hline
Total Deposits (US$ mil) & 8,421 & 11,393 & 12,017 & 13,808 & 13,779 & 14,296 \\
o/w Households & 4,752 & 5,867 & 6,413 & 7,672 & 7,242 & 8,112 \\
o/w Enterprises & 2,878 & 4,519 & 4,290 & 4,710 & 4,962 & 4,732 \\
o/w Other Deposits & 791 & 1,007 & 1,254 & 1,426 & 1,575 & 1,452 \\
Total Deposits/Total Assets & 39\% & 41\% & 41\% & 48\% & 51\% & 50\% \\
Total Household/Enterprise Deposits & 7,630 & 10,386 & 10,763 & 12,382 & 12,204 & 12,844 \\
Total Household/Enterprise Credit & 12,920 & 15,771 & 12,819 & 10,883 & 10,004 & 10,381 \\
Net Household/Enterprise Deposits & (5,290) & (5,385) & (2,056) & 1,499 & 2,200 & 2,463 \\
\hline
\end{tabular}
\caption{Private Sector Deposits in Hungary}
\end{table}

\textsuperscript{241} (i) Current account deficit: US$ 3,938 million; (ii) private transfers: US$ 732 million; therefore (i) less (ii) = US$ 3,206, which was 8.4 percent of 1993 GDP.
Investment would have been higher in Hungary if a more accelerated privatization schedule had been followed. The Czech Republic has shown impressive mobilization of investment resources, predicated largely on its rapid privatization strategy (see Section III). Despite a gradualist approach to privatization, Hungary has succeeded in attracting more foreign investment than any other country in the region. By comparison, FDI in Hungary has been about four times that in Poland since 1991, and about 17 times Poland's FDI on a per capita basis. Nevertheless, lenders and investors were shaken in early 1995 by the GoH reversal of the HungarHotel privatization. Mid-1995 decisions against finding strategic partners for the national oil and gas company (MOL) were a setback for foreign investors. Considering (i) that Hungary only achieved 20 percent of its privatization sales target in 1994 (see Section III), and (ii) its precarious fiscal state, Hungary will need to accelerate privatization for fiscal relief and added investment in the economy. More recently, GoH has adopted a more aggressive approach to privatization. Such a reversal is expected to increase FDI in 1995-1997 as GoH sells off most of the remaining state sector, including partial or total stakes in many blue chip infrastructure companies (see Section III).

Private Sector Share of International Trade

Hungary's level of trade in goods and services was 72 percent of GDP from 1989-1994, which is comparatively low in the region despite its open trade and investment regime. This level of trade-to-GDP declined in 1993-1994 due to the significant decline in recorded merchandise exports. Total trade was about US$ 152 billion from 1989-1994. Hungary previously ran slight current account deficits averaging US$ 515 million from 1989-1992, or less than 2 percent of GDP. However, 1993-1994 showed significant deterioration, with deficits of US$ 3.5 billion in 1993 and US$ 4 billion in 1994, each about 10 percent of GDP. This decline in performance was driven by (i) reduced agricultural and industrial exports; (ii) shrinking but still significant net interest expense resulting from Hungary's high debt load; and (iii) real wage increases. Nevertheless, many private enterprises (including smaller ones) are beginning to demonstrate competitiveness, particularly in piston engines, footwear, a range of

Table 14: Investment Trends in Hungary

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Investment</td>
<td>7,118</td>
<td>8,130</td>
<td>6,524</td>
<td>5,412</td>
<td>6,975</td>
<td>8,389</td>
</tr>
<tr>
<td>o/w Domestic</td>
<td>6,931</td>
<td>7,793</td>
<td>5,065</td>
<td>3,941</td>
<td>4,646</td>
<td>7,243</td>
</tr>
<tr>
<td>o/w Foreign</td>
<td>187</td>
<td>337</td>
<td>1,459</td>
<td>1,471</td>
<td>2,329</td>
<td>1,146</td>
</tr>
<tr>
<td>Foreign/Total Investment</td>
<td>2.6%</td>
<td>4.1%</td>
<td>22.4%</td>
<td>27.2%</td>
<td>33.4%</td>
<td>13.7%</td>
</tr>
<tr>
<td>Foreign Investment/GDP</td>
<td>0.6%</td>
<td>1.0%</td>
<td>4.4%</td>
<td>4.0%</td>
<td>6.1%</td>
<td>2.8%</td>
</tr>
<tr>
<td>Total Fixed Investment/GDP</td>
<td>25.8%</td>
<td>23.9%</td>
<td>19.8%</td>
<td>15.5%</td>
<td>19.9%</td>
<td>21.5%</td>
</tr>
</tbody>
</table>

Sources: Internal World Bank reports.

The following export products declined by 10 percent or more per year from 1989-1993: vegetable saps, milled agricultural items, nickel products, cement, fish, fur, wool, ores and slag, fibers, fats, food residues, dairy products, and fertilizers. Fertilizers, meat, and iron and steel showed the biggest absolute declines during the same period. See B. Hoekman and G. Pohl, "Enterprise Restructuring in Eastern Europe", World Bank, 1995.
agribusiness products, and motor vehicle parts.\textsuperscript{243} Exports to the EU increased an average 11 percent per year from 1989-1993, giving Hungary EU market share of .81 percent in 1993 compared to .58 percent in 1989.

Like the other Visegrad countries, Hungary has experienced a proportional shift in trade away from its former CMEA trading partners and towards EU markets. Hungary's gradualist approach had shifted trade toward the European Community earlier than Czechoslovakia and Poland, and trade with these markets accounted for about one-quarter of Hungary's international trade in 1989. By 1994, the EU accounted for about half of Hungary's trade value. Meanwhile, trade with the former centrally planned economies decreased from about 35 percent of total trade in 1989 to about one-quarter of total trade value in 1994. Hungary also continues to maintain a diversified trading position, having significant trade relations with non-EU and non-CMEA countries. In 1989, these trade values approximated 40 percent of total trade. In 1994, trade in this direction was nearly 30 percent of total.

4. Poland

The Polish private sector is increasingly prominent in the economy despite the continued presence of about 5,000 SOEs (see Section III), low financial intermediation rates, and weak capital markets and investment. Private sector share of GDP has increased from 28 percent in 1989 to 58 percent in 1994, therefore doubling in a period of six years (see Table 15). In US dollar terms, private sector output increased nearly fourfold from 1989-1994, from US$ 16.4 billion in 1989 to US$ 53.0 billion in 1994. Most growth has come from new private companies, with the highest number of owner-operated businesses in the Visegrad region (nearly five million) sparking much of the growth. Domestic investment declined steadily from 1990-1992, from 38.5 percent of GDP in 1989 to 15.2 percent in 1992. Nevertheless, investment began to rebound slightly in 1993-1994, primarily from domestic sources (albeit at relatively low rates\textsuperscript{244}), and this has played a key role in Poland's buoyant expansion of 5.5 percent real GDP growth in 1994.\textsuperscript{245} In recent years, productivity and exports have increased, including in the industrial sector, which remains Poland's largest sector. New

<table>
<thead>
<tr>
<th>Table 15: Private Sector Shares/Trends in Poland</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
</tr>
<tr>
<td>Employment</td>
</tr>
<tr>
<td>Consumption</td>
</tr>
<tr>
<td>Credit</td>
</tr>
</tbody>
</table>

Sources: Central Statistical Office; "Poland: Policies for Growth with Equity", World Bank, 1994; internal World Bank reports; EBRD.

\textsuperscript{243} Hungary's share of "traditional" exports (greater than ECU 3 million in 1989 value) as a percentage of total exports to EU markets declined from 59 percent in 1989 to 35 percent in 1993. Meanwhile, its fastest growing exports to EU markets in 1993 were reciprocating piston engines, men's and women's footwear with soles, live animals (lambs less than one year old, and live domestic cows), processed foods (fatty livers of domestic geese, and meat and edible meat offal), parts of electrical machinery, parts of motor vehicles, and articles of iron and steel. See B. Hokekm and G. Pohl, "Enterprise Restructuring in Eastern Europe", World Bank, 1995.

\textsuperscript{244} Based on official statistics, fixed investment was only 15.6 percent and 16.0 percent of GDP, respectively, in 1993 and 1994. On a dollar basis, this represents a significant increase because of steady GDP growth. However, on a rate basis, fixed investment is still not as high as is required for sustainable long-term growth.

\textsuperscript{245} Estimates for 1995 show at least 6 percent real growth.
private businesses are showing better inventory management, and improved production technologies and systems. Imports are showing an increasing percentage of capital goods, indicating investment in new production technologies in export industries.

Notwithstanding recent growth and many favorable trends, significant weaknesses remain. These include: (i) thousands of SOEs and employee/management-owned (privatized) firms are running up losses; (ii) many enterprises have been unable or failed to invest in needed property, plant and equipment, leading to less competitiveness; (iii) arrears to bank, trade and government creditors have increased, or in response, transactions only occur on a cash or barter basis, reducing liquidity in the market for private businesses; and (iv) many businesses have failed to retain earnings in their businesses, opting to purchase consumer goods or invest in properties unrelated to their core businesses, weakening their long-term chances of success. On a sectoral basis, agriculture was flat from 1991-1994, and many troubled industries remain to be divested or liquidated. This could be difficult to deal with in a country with official unemployment rates of 16 percent (although these rates declined in 1995). The risk of continued state retention or mass commercialization of enterprises as a substitute for privatization could prolong the restructuring process, ultimately slowing economic growth (see Section III). Table 15 shows significant private sector strength over the years of reform, and with that the likelihood of additional absorptive capacity as the economy grows in real terms at about 5-6 percent, as projected for the coming years.

Private Sector Contribution to GDP

The Polish private sector now contributes more than half to total GDP, representing a 100 percent increase since 1989. In terms of total output, the Polish private sector now produces nearly four times what it produced in 1989, mainly in trade and industry (although most industry is still in the state sector). Table 16 shows private sector contribution to GDP since 1989, as well as sectoral distributions during this period. The trends show steady and significant private sector growth in industry and services, and continued dominance in agriculture (although this sector has only contributed 7 percent of GDP since 1991). Private sector shares of total GDP have generally doubled in industry and services (aside from communications) since 1990. However, SOEs still dominate industry (62 percent of GDP) and transport (50-60 percent), including several infrastructure and utility companies (see Section III).

---

246 The agricultural sector improved in 1995, largely on the strength of improved weather. Nevertheless, structural weaknesses remain regarding productivity and efficiency. Individual farms are small, input use is constrained by cash shortages, technology is obsolete, and marketing is localized and inefficient. The introduction of wholesale markets, better storage facilities, improved road systems, and a restructured agricultural banking system will help with primary sector production. Nevertheless, the agricultural sector remains weak and in need of major investment and restructuring.

247 Registered unemployment was 15.1 percent at the end of April 1995, and were expected to come down further by year end. However, significant regional disparities persist. Unemployment rates were far higher in the four northern regions of Słupsk (28.6 percent), Suwałki (26.9 percent), Koszalin (26.5 percent) and Olsztyn (26.4 percent).

248 Recent efforts by Parliament to exercise greater control of the privatization process are an indication the risk is real.
Given limited output from the agricultural sector, most private sector growth has been in industry and services. Private sector GDP of about US$ 53 billion in 1994 was composed of (i) US$ 30.1 billion in services; (ii) US$ 17.2 billion in industry; and (iii) US$ 5.7 billion in agriculture. Box 17 highlights the differing trends between agriculture, which stagnated from 1991-1994, and industry, which has grown significantly since 1991. Overall growth has been supplemented by significant informal activity in all sectors (primarily services), worth billions of dollars and estimated to be 20 percent of 1993 GDP. Informal trade and contracting is primarily found in the metropolitan areas, and in regions close to borders with Russia (Kaliningrad), Lithuania, Belarus, Ukraine and Germany.

<table>
<thead>
<tr>
<th>Table 16: An Overview of the Polish Private Sector Contribution to GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Year</strong></td>
</tr>
<tr>
<td>Total GDP (US$ mil)</td>
</tr>
<tr>
<td>o/w Agriculture</td>
</tr>
<tr>
<td>o/w Industry</td>
</tr>
<tr>
<td>o/w Services</td>
</tr>
<tr>
<td>Private GDP (US$ mil)</td>
</tr>
<tr>
<td>Agriculture</td>
</tr>
<tr>
<td>Industry</td>
</tr>
<tr>
<td>Services</td>
</tr>
<tr>
<td>Private Sector Share of:</td>
</tr>
<tr>
<td>Agriculture</td>
</tr>
<tr>
<td>Industry</td>
</tr>
<tr>
<td>Construction</td>
</tr>
<tr>
<td>Transport</td>
</tr>
<tr>
<td>Communications</td>
</tr>
<tr>
<td>Trade</td>
</tr>
</tbody>
</table>

Sources: Central Statistical Office (GUS); World Development Reports, 1991-1995; World Tables, 1993; internal World Bank reports; World Bank staff estimates; EBRD; Oxford Analytica.

249 As in other country statistics, these figures differ from other sources based on classification models.

250 These trends were reinforced in 1994, with industry growing 10 percent (constant prices) while agriculture declined five percent (constant prices). However, agriculture has shown signs of improvement in 1995.

251 Earlier estimates showed (i) Germans spend about DM 5 billion (US$ 4 billion) per year in cross-border trade; and (ii) trade with Poland’s eastern neighbors was about US$ 2 billion. More recent estimates indicate a lower aggregate figure approximating US$ 3 billion.
Box 17: A Tale of Two Sectors

**Agriculture:** The agricultural sector has been flat since 1991, with slight increases in output but a constant 7% of GDP. Most agriculture is private and small-scale. The average farm has 6.3 hectares. About two thirds of farms have less than 10 hectares, but make up 57% of total arable land. Agriculture employs 27% of the workforce (3.7 million), of which 3.4 million are private. The state and cooperative sector has virtually disappeared, with 700,000 employed in 1989 down to 300,000 in 1993. Rural unemployment has remained high in areas where state farms/ cooperatives predominated. The agricultural sector is inefficient, accounting for 12-14% of GDP in 1989-1990, but declining to 7% thereafter with the same number of people employed. Declining labor productivity, poor profits, weak investment, less use of inputs, and decreased CMEA demand for agricultural machinery have all resulted in lower demand, increased competition from imports, and foregone market share. These effects were compounded in 1994 by drought, resulting in a 19% decline in harvest, particularly potatoes, cereals, sugar beet, fruit and vegetables. Agricultural incomes are now 77% of the rest of the economy, and 57% of 1985 levels. Despite all of these problems, the agro-processing sector is showing improvement, with increased export sales and investment in food processing and beverage manufacturing.

**Industry:** The industrial sector increased output twofold between 1990 and 1993. During this period, private sector industrial output increased fourfold. Private industry is prevalent in the fastest growing sub sectors (footwear, textiles, chemical products). The fastest industrial increases have been in textiles, chemicals, foodstuffs and footwear due to competitively priced labor and close proximity to EU markets.

**Winners and Losers:** Highest profit margins have been in 1) post and telecommunications, 2) pharmaceuticals, 3) brewing, 4) paints and lacquers, 5) tobacco, and 6) sugar and confectioneries. Biggest loss rates in 1994 were in 1) footwear, 2) metal castings, 3) metallurgy and machinery, 4) communications equipment, 5) shipping, and 6) agricultural machinery and equipment. Many of the loss-making enterprises are state sector enterprises that can not compete with lower cost private companies that have invested in new equipment and systems (footwear). Private sector industrial sales were up 37% in the first half of 1994, while state industrial sales were down 1%.

Sources: Internal World Bank reports; Oxford Analytica.

### Private Sector Employment and General Unemployment

Poland’s total labor force in 1994 was about 17.8 million. Among those employed, 61 percent were employed in the private sector. Table 17 shows private sector share of total employment in 1992-1994. In 1994, the private sector employed a majority of people working in agriculture (95 percent), trade (94 percent), construction (78 percent), "other material production" (81 percent), tourism (61 percent) and non-material community services (54 percent).

---

232 These figures differ from Table 17, where 1994 agricultural sector employment is estimated at 4.0 million, of which 3.8 million are private. The Central Statistical Office showed total employment of 3.8 million in agriculture and forestry at end 1993.

233 Textile products include threads, clothing and fabrics. Chemicals products include phenol, sulfuric acid, synthetic fibers and rubber, fertilizers and bulk chemicals. Foodstuffs include a range of food and beverages.
Determining firm size is difficult in Poland, although it is estimated that there are about 4.6 million microenterprises (self-employed), another 22,000 private firms with employment of 21-500, several hundred firms with foreign investment, and about 5,000 SOEs (and other public agencies) employing a total of 7.6 million people. With about 4.8 million people working in the non-agricultural private economy and a minimum 600,000 private non-agricultural enterprises, the average private non-farm enterprise employs an average of eight people. Thus, Polish businesses are generally small-scale. However, their dynamism is demonstrated by the growth in private sector industry and services, the creation of 3.5 million new jobs between 1991-1993, and real wage increases of 3.5-4.0 percent in 1994 compared to stagnation in the state sector and 14-16 percent official unemployment.

Unemployment remains a stubborn problem in Poland, having risen from a low 6.3 percent (1.1 million) in 1990 to a high 16 percent (2.9 million) in 1993-1994. This rate has come down in 1995, and is expected to be as low as 14 percent by end 1995. An estimated 700,000-1.1 million jobs exist in the informal sector (which are not included in official statistics), which would reduce the unemployment rate by about 5 percent (to 10-12 percent) and bring Polish unemployment to current EU levels. However, as in other transition countries, significant numbers of redundant employees are kept on by SOEs, keeping unemployment rates artificially low. Thus, along with wage arrears, part-time work, and other methods of "maintaining" employment, it is difficult to arrive at an accurate unemployment figure. Irrespective of the real unemployment rate, the major challenge ahead for Poland is industrial restructuring in the state sector, which will lead to layoffs. GoP has a range of concerns regarding the structure and distribution of unemployment. Structurally, 46 percent of those currently unemployed have been so for greater than one year. One-third of the unemployed had registered for benefits at an earlier point. Generational concerns have risen, as the unemployment rate among those 15-25 years old is twice the national average, or more than 30 percent. Regionally, unemployment has persisted at 25-30 percent rates in some areas (often where state farms and cooperatives have failed), while more buoyant urban economies (Warsaw, Krakow, Katowice, Poznan) have comparatively low 8-10 percent unemployment rates.

---

254 The Central Statistical Office projects 14.3 percent.
Private Sector Credit

As in Hungary, the Polish private sector has grown in spite of difficulties accessing bank credit. Table 18 highlights lending trends in Poland since 1991, showing about 70 percent of lending goes to GoP and SOEs. The only major shift has been the curtailment of lending to SOEs in favor of investments in GoP securities, which help finance Poland's entitlement-driven fiscal deficits. Banks are reluctant to extend credit to private enterprises, particularly as most firms are very small-scale (as well as imperfections in the legal and regulatory environment regarding loan recovery, as described in Section II). The share of credit to the private sector has actually declined nearly 2 percent (as a share of total credit) since 1991, despite real GDP growth averaging nearly 4 percent since 1992, largely due to private industry and services. Table 18 shows lending trends in Poland from 1991 to 1994.

<table>
<thead>
<tr>
<th>Table 18: Lending Trends in Poland</th>
</tr>
</thead>
<tbody>
<tr>
<td>------</td>
</tr>
<tr>
<td>Net Dom. Credit (OZ trillions)</td>
</tr>
<tr>
<td>o/w to Government, net</td>
</tr>
<tr>
<td>o/w to State Enterprises</td>
</tr>
<tr>
<td>o/w to Private Enterprises</td>
</tr>
<tr>
<td>o/w to Private Households</td>
</tr>
<tr>
<td>Net Dom. Credit (US$ billions)</td>
</tr>
<tr>
<td>o/w to Government</td>
</tr>
<tr>
<td>o/w to State Enterprises</td>
</tr>
<tr>
<td>o/w to Private Enterprises</td>
</tr>
<tr>
<td>o/w to Private Households</td>
</tr>
<tr>
<td>Share of Credit</td>
</tr>
<tr>
<td>Government</td>
</tr>
<tr>
<td>State Enterprises</td>
</tr>
<tr>
<td>Private Enterprises</td>
</tr>
<tr>
<td>Private Households</td>
</tr>
<tr>
<td>Total State Credit</td>
</tr>
<tr>
<td>Total Private Credit</td>
</tr>
</tbody>
</table>

Sources: National Bank of Poland; Central Statistical Office; internal World Bank reports; IMF.

On a net flow basis, total credit increased US$ 8.0 billion between 1991 and 1994, of which US$ 2.0 billion was directed to the private sector. This increment was fairly evenly divided between loans to households and loans to private enterprises. While this is an increase, not a decline (as in Hungary), the real increase was in direct financing of the GoP by an incremental US$ 8.5 billion. The big loser was SOEs, which received US$ 2.6 billion less in direct credit flows. With at least 600,000 private non-farm enterprises in Poland, average credit to private enterprises would approximate US$ 17,000, useful for small-scale working capital needs but unlikely to assist medium-scale or larger firms with term investment requirements. In terms of general flows, the net increase to GoP was more than four times the increment to the private sector. On the one hand, with lending rates ranging from 33-57 percent into

255 Small firms with small credit requests drive up the administrative costs and overhead ratios of banks. For banks to be efficient, they often prefer to "wholesale" credit in larger amounts to reduce their per-unit cost of operations.
early to mid-1995, most firms have been unable to cover the cost of borrowing unless they engage in trade or other rapid-turnover businesses. On the other hand, banks prefer to invest in GoP securities with 10 percent net spreads against deposits, while the private sector has to identify alternative sources of liquidity. Thus, enterprises have found credit to be both costly and in short supply, increasing reliance on trade credit. The overall increase in inter-enterprise debt combined with tight firm-level liquidity has led to an increase in inter-enterprise arrears, and partly explains why the inflation rate has remained high.

Private Sector Deposits

Total deposits have increased from US$ 21.4 billion in 1991 to US$ 29.3 billion in 1994, an increment of US$ 22 per capita per year. Private sector deposits account for about three-quarters of total deposits, equivalent to US$ 22,498 million in 1994. Most of these deposits are from private households, whose share of total deposits ranged from 55-60 percent from 1991-1994. Table 19 shows relative shares of deposits and loans, indicating that private households are major net lenders to the banking system, while government, SOEs and private enterprises are net borrowers relative to deposits.

---

256 Rates began to decrease in mid-1995 as the inflation rate seems increasingly under control, albeit still high (about 25 percent expected for 1995). Interest rate reductions were announced by the National Bank of Poland (NBP) effective May 29 and September 18, 1995. The first reduction brought NBP rates down by 4 percent, and the second reduction by 2 percent. Nevertheless, the lowest rates charged by commercial banks to their best clients are still about 31 percent. Most customers do not qualify for those rates because banks perceive them to be too risky.

257 Maintaining high spreads between securities and deposits is a means of recapitalizing banks without explicitly directing budgetary resources for this purpose.

258 Enterprises routinely raise the price of their goods and services when extending trade credit to compensate for potential losses on receivables.

259 Total deposits were US$ 21,414 million at end 1991, or US$ 557 per capita. At end 1994, total deposits were US$ 29,332 million, or US$ 764 per capita. These average annual increases of US$ 69 approximate 1.5 percent of annual per capita incomes on a purchasing power parity basis.
### Table 19: Private Sector Deposits in Poland (1991-1994)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Deposits</th>
<th>o/w Government*</th>
<th>o/w State Enterprises</th>
<th>o/w Private Enterprises</th>
<th>o/w Private Households</th>
<th>Gov't/SOE Deposits</th>
<th>Gov't/SOE Credit</th>
<th>Net Public Deposits</th>
<th>Priv Sector Deposits</th>
<th>Private Sector Credit</th>
<th>Net Private Deposits</th>
<th>o/w Private Enterprises</th>
<th>o/w Households</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ mil</td>
<td>%</td>
<td>$ mil</td>
<td>%</td>
<td>$ mil</td>
<td>$ mil</td>
<td>%</td>
<td>$ mil</td>
<td>%</td>
<td>$ mil</td>
<td>%</td>
<td>$ mil</td>
<td>%</td>
</tr>
<tr>
<td>1991</td>
<td>21,414</td>
<td>100.0</td>
<td>24,426</td>
<td>100.0</td>
<td>23,857</td>
<td>100.0</td>
<td>29,332</td>
<td>100.0</td>
<td>7,918</td>
<td>100.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td>24,426</td>
<td>100.0</td>
<td>3,297</td>
<td>13.5</td>
<td>3,735</td>
<td>15.3</td>
<td>2,981</td>
<td>12.5</td>
<td>2,651</td>
<td>9.0</td>
<td>(68)</td>
<td>(3.7)</td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td>23,857</td>
<td>100.0</td>
<td>3,735</td>
<td>15.3</td>
<td>2,981</td>
<td>12.5</td>
<td>4,183</td>
<td>14.3</td>
<td>238</td>
<td>(4.1)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td>29,332</td>
<td>100.0</td>
<td>2,901</td>
<td>13.5</td>
<td>3,438</td>
<td>14.1</td>
<td>3,694</td>
<td>15.5</td>
<td>4,852</td>
<td>16.5</td>
<td>1,951</td>
<td>3.0</td>
<td></td>
</tr>
<tr>
<td></td>
<td>7,918</td>
<td>100.0</td>
<td>(68)</td>
<td>(3.7)</td>
<td>(238)</td>
<td>(4.1)</td>
<td>(1,951)</td>
<td>3.0</td>
<td>1,951</td>
<td>3.0</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Government deposits include insurance and social security.

Unlike enterprises whose deposits are primarily local currency demand deposits, households have half of their deposits in savings/time deposits and the other half in foreign currency. This reflects logical savings behavior, particularly as inflation and interest rates are still high, although real interest rates on deposits remain negative or close to zero on a range of deposit instruments. The combination of negative real interest rates on deposits and limited access to credit has contributed significantly to Poland's low level of financial intermediation,260 even by Visegrad261 and global standards. This has not prevented Poland from experiencing real GDP growth since 1992, largely spurred by the more than 20 percent GDP contribution from the informal sector (see "Private Sector Contribution to GDP" above). However, fixed investment has declined or stagnated as a percentage of GDP since 1991, and low financial intermediation rates may undermine needed long-term investment, particularly as Poland has done a poor job of

260 While lending rates to banks' best customers are not high on a real basis relative to CPI inflation measures, rates are reported to be 15-20 percent higher for non-preferred customers. Thus, lack of access to and the high cost of credit have contributed to financial disintermediation.

261 The Visegrad states had the following M2/GDP ratios in 1994 when including foreign currency: (i) Czech Republic: 81 percent; (ii) Hungary: 50 percent; (iii) Poland: 35.5 percent; (iv) Slovakia: 64 percent. When measuring exclusively on the basis of the domestic currency component of M2, intermediation rates are: (i) Czech Republic: 68 percent; (ii) Hungary: 34 percent; (iii) Poland: 22 percent; (iv) Slovakia: 55 percent. Thus, Poland enjoyed the highest rate of real GDP growth (5.5 percent) despite the lowest rates of financial intermediation in the region.
attracting foreign investment as a supplement. Table 20 highlights Poland’s negative real rates on deposit instruments, high lending rates (relative to PPI, and considering these are the lowest lending rates available), and low financial intermediation (22 percent) and investment (16 percent) relative to GDP.

<table>
<thead>
<tr>
<th>Table 20: Deposit Mobilization, Investment and Disintermediation in Poland</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPI Inflation Rates (end-of-period)</td>
</tr>
<tr>
<td>Demand Deposits</td>
</tr>
<tr>
<td>3-Month Deposits (end-of-period)</td>
</tr>
<tr>
<td>6-Month Deposits (end-of-period)</td>
</tr>
<tr>
<td>6-Month Real Deposit Rates</td>
</tr>
<tr>
<td>PPI Inflation Rates (end-of-period)</td>
</tr>
<tr>
<td>Nominal Lending Rates (best customers)</td>
</tr>
<tr>
<td>Real PPI Lending Rates (best customers)</td>
</tr>
<tr>
<td>Real CPI Lending Rates (best customers)</td>
</tr>
<tr>
<td>Domestic and Foreign M2/GDP</td>
</tr>
<tr>
<td>Fixed Investment/GDP</td>
</tr>
</tbody>
</table>

Sources: National Bank of Poland; Central Statistical Office; internal World Bank reports.

Private Sector and Foreign Investment

Private investment increased 56 percent in the first half of 1994, as opposed to an 8 percent increase in the public sector. Given that the private sector share of GDP has doubled from 1990-1994, it is very likely that the private sector accounts for at least two-thirds of new investment. This would approximate US$ 12 billion in 1994 alone.\(^{262}\) Most private investment has been in industrial machinery and equipment, with many

<table>
<thead>
<tr>
<th>Table 21: Investment Trends in Poland</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Domestic Investment</td>
</tr>
<tr>
<td>o/w Foreign</td>
</tr>
<tr>
<td>Foreign/Total Investment</td>
</tr>
<tr>
<td>Foreign Investment/GDP</td>
</tr>
<tr>
<td>Fixed Investment/GDP</td>
</tr>
</tbody>
</table>


---

\(^{262}\) Fixed investment was 16.0 percent of 1994 GDP, or US$ 14.6 billion. However, total investment exceeded fixed investment as a share of GDP by 3.6 percent from 1991-1993. If the same were true in 1994, total investment would have been about 19.5 percent of GDP, or nearly US$ 18 billion. If the private sector accounted for at least two-thirds, this would approximate US$ 12 billion.
of these producers engaged in the exportation of textiles, furniture and wood products, and transportation equipment. Table 21 highlights fixed investment trends in Poland since 1989.

While private investment is proceeding and helping to power real GDP growth, Poland has achieved this with very weak performance in attracting foreign investment. Total FDI from 1991-1994 was US$ 1.6 billion (net of portfolio investments), from a base of zero before that. This compares with Hungary (US$ 6.6 billion) and the Czech Republic (about US$ 3 billion), each of which have populations of about one quarter and GDPs of about 40 percent that of Poland. Even the Slovak Republic has a better per capita FDI performance than Poland, although this has begun to change in 1995. Poland’s FDI is small-scale in orientation, with average FDI per joint venture about US$ 80,000, and the median investment below US$ 50,000. Apart from the auto industry (Fiat, Daimler-Benz, General Motors, Ford, and more recently, a major commitment from Daewoo), food processing sector (Coca-Cola, PepsiCo, British Sugar, McVities, Nestle, Gerber), telecommunications (Alcatel, France Telecom) and electrical and engineering sectors (Asea Brown Boveri, Thomson, Philips), Poland has attracted limited and small-scale FDI. As Poland begins to face (i) additional restructuring requirements in the state sector along with (ii) eventual constraints to growth for individual private enterprises, it is likely to need additional sources of investment. A series of factors may contribute to improved performance: (i) debt forgiveness in 1994 from the London and Paris Clubs, equivalent to US$ 9 billion, significantly reduced Poland’s external debt to 41 percent of 1994 GDP compared to 55 percent of 1993 GDP; (ii) increasing growth in exports and the domestic consumer market, spurred by increasing foreign exchange reserves from export growth; and (iii) the prospect of large infrastructure contracts for motorway construction and new gas pipelines, all part of a plan to integrate European economies.

Private Sector Share of International Trade

As with the economy as a whole, the private sector share of international trade is steadily increasing. The private sector accounted for 48 percent of exports and 65 percent of imports at mid-1994, compared to 41 and 60 percent, respectively, at mid-1993. Thus, with international trade (goods and services) approximating US$ 38 billion in 1994, the private sector share likely was about US$ 22 billion. In addition, the approximately US$ 5 billion in informal cross-border trade with its neighbors likely increased trade to the US$ 45 billion range, with the private sector accounting for about two-thirds. Poland is poised to increase trade with its eastern and northern neighbors in the Baltics, Russia.

---


264 The Polish Agency for Foreign Investment reported the following distribution by rank and percentage in 1994: (i) US (33 percent); (ii) multinationals (18 percent); (iii) Germany (9 percent); (iv) Italy (8 percent); (v) France (6 percent); (vi) Holland; (vii) Austria; and (viii) UK. In terms of commitments, the US and Italy accounted for two-thirds of future commitments.

265 FDI of US$ 1.6 billion has been attracted by nearly 20,000 joint ventures, averaging about US$ 80,000 per investment. However, only 267 joint ventures have attracted US$ 1 million or more. Thus, US$ 1.3 billion or less applies to virtually all joint ventures, leading to an average for the rest of US$ 65,000. The Polish Agency for Foreign Investment claims about 75 percent of registered joint ventures had attracted FDI of less than US$ 50,000.

266 Russia currently accounts for about 5 percent of Poland’s exports and 7 percent of imports.
Ukraine, and Belarus. However, this will require resolution of indebtedness issues with its former CMEA trade partners, as was recently achieved by Hungary.

The shift in trade patterns away from centrally planned economies towards the EU has been a consistent feature since 1990. In 1989, Polish imports and exports were about one-third to/from former centrally planned economies, the EU, and other regions. By 1994, only 10 percent of trade was with centrally planned economies, while about 60 percent of total trade was with the EU.

Merchandise imports have accounted for about 22.5 percent of consumption since 1991. Dollar value purchases between 1991-1993 increased significantly in manufactured goods (132 percent), chemicals (71 percent), and food and live animals (19 percent), while imports of minerals and fuels have declined by 20 percent. In these same categories, exports of chemicals (29.5 percent), food and live animals (28 percent) and mineral fuels and lubricants (14 percent) declined, while exports of manufactured goods were basically flat. These statistics appear to indicate (i) a net decline in critical trade classifications due to imported goods being more competitive; and (ii) pent-up demand for consumer goods after the wrenching economic changes in 1990. However, machinery and transport equipment (26 percent of total 1993 trade) showed a 5 percent increase in imports and an 8 percent increase in exports compared to 1991, partly reflecting the retooling of Poland's industrial sector. Exports in 1995 are expected to show major increases, including in sectors that previously were flat or showed declines.

Retooling has been demonstrated with a structural change in Polish export trade with EU countries. Poland had about 1.54 percent market share in EU export markets, up from .85 percent in 1989. Clothing, furniture and wood products, and transportation equipment (cars, ships, aircraft) were the most important growth areas for Polish exports. Agriculture and foodstuff exports to EU countries were ECU 229 million less in 1993 compared to 1989, accounting for 85 percent of declining group exports to EU markets. The share of "traditional" exports (greater than ECU 3 million in 1989) declined from 74 percent in 1989 to 50 percent in 1993, indicating the same kind of structural change that has occurred in Bulgaria, CSFR, Hungary, Romania and several FSU countries.

5. Slovak Republic

In contrast to the Czech Republic, which has continued to privatize (at least partially) since 1993, the Slovak Republic has made little progress in privatizing state enterprises since the first wave of mass privatization ended in 1993 (see Section III). Nevertheless, private sector development has proceeded, and the private sector now accounts for 58 percent of GDP and 55 percent of employment, both significant increases since 1989 when the transition began and the 1993 split of the CSFR. The Slovak economy is now characterized by less state involvement, liberalized prices, lower barriers to trade, and little fear of direct expropriation. However, significant restructuring needs remain for the Slovak Republic to become globally competitive on a sustainable basis. While the Slovak economy has improved since 1993, the country still lacks needed investment for restructuring. As a result, a state-oriented approach has led to an increase in net lending from the banking system to GoS, much of which is then allocated to the troubled state enterprise sector. Failure to obtain needed private investment could

267 Poland's leading "new" export products include sea going vessels, civil aircraft, frozen fillets of fish, iron and steel, discharge lamps, live domestic cows, womens' trousers, meat and edible offal, lignite (unagglomerated), and mens' footwear with soles. See B. Hoekman and G. Pohl, "Enterprise Restructuring in Eastern Europe", World Bank, 1995.
undermine its competitive position in the medium term, particularly as competition increases from Poland, Hungary and other neighboring countries. Recent decisions to terminate voucher privatization, constrain IPFs, reinforce enterprise management, and indefinitely extend state control over hundreds of SOEs (directly or via the NPF) bode poorly for restructuring and investment prospects (see Section III).

Private Sector Contribution to GDP

As in the other Visegrad countries, private sector contribution to GDP and employment has increased steadily in recent years. Private sector contribution to GDP was 58 percent in 1994, compared to a mere 27 percent in 1991. In dollar terms, this represents a doubling of private sector output in just three years. The increase has come primarily from services which were privatized during the first wave, although increases have come from other sectors as well, as the private sector now accounts for 54 percent of industry, 74 percent of construction, 88 percent of retail trade, and 56 percent of road transport. However, real growth has not been well distributed, and most of it has been found in services around Bratislava, sparked by an increase in consumption and exports. Exports have increased due to rising productivity after devaluation of the Slovak crown. However, there has been no real incremental investment, and longer term, this could undermine industrial competitiveness. As is possible in Poland, further delays in enterprise privatization could lead to a costly wave of bankruptcies and liquidations in the future.

In terms of pre-tax profitability, official statistics indicate strong performance only in (i) the electricity, gas and water supply sector, the ownership of which is public; (ii) transport and storage, which is mainly private; and (iii) communications, which is mainly public (see Table 23). Major loss-making sectors are agriculture and forestry, and machinery and equipment manufacturers. Total 1993 pre-tax profits for 4,678 enterprises with more than 25 employees were SK 25.8 billion (nearly US$ 800 million), or an average of about SK 1 million (US$ 30,000) per registered enterprise. While these statistics are not divided by state and private ownership, negative or flat trends and low pre-tax profitability undercut investment. Aside from power, transport and telecommunications, the enterprise sector in Slovakia in 1993 was loss-making or flat. Given the improved economy in 1994, it is likely that several of these loss-making sectors generated profits, or at least reduced their losses compared to 1993. Nevertheless, even with improved performance, 1994 also showed a significant decline in fixed investment (from 22 percent to 17 percent of GDP), which may indicate that profitability still remains low or negative in most sectors.

The private sector has grown steadily as small-scale privatization proceeded quickly through the voucher and auction schemes. As indicated by Table 24, the number of private enterprises grew rapidly with the introduction of mass privatization. Considering that Czechoslovakia had virtually no private sector as recently as 1989, significant changes occurred in the ownership structure of the economy very quickly. Nevertheless, the number of SOEs did not decline significantly until 1994 (see Table 24), and

| Table 22: Private Sector Shares/Trends in the Slovak Republic |
|------------------|--------|--------|--------|--------|
| GDP              | 27%    | 32%    | 39%    | 58%    |
| Employment       | 16%    | 25%    | 43%    | 55%    |
| Consumption      | 71%    | 69%    | 70%    | 70%    |
| Credit           | 29%    | 35%    | 38%    | 39%    |

Sources: National Bank of Slovakia; Slovak Statistical Office; internal World Bank reports.
much of the decline since 1994 has been based on mergers, consolidation, and dubious privatization transactions. The state sector remains prominent in the industrial and banking sectors, and continues to represent 42 percent of GDP (1994). In addition, because nomenklatura privatization occurred after 1992 as a reaction against voucher privatization (see Section III), many of the registered private enterprises are still managed and controlled in a manner that defers needed operational restructuring for a competitive market economy. Recent GoS decisions will likely continue this trend.

Some restructuring has occurred, as prompted by industrial decline in 1989-1992 resulting from lost CMEA, arms, and heavy machinery markets. During this period, Slovakia experienced a major loss of jobs, particularly in the SOE industrial sector, but also in the small shop sector. Some management changes were made, and financial discipline in many cases improved. However, the risk to the Slovak economy is if the magnitude of change has not been sufficient to make the enterprise sector competitive on a sustainable basis. Due to pervasive weaknesses at the firm level, delays in the restructuring of many larger enterprises, and limited ability to generate needed investment from domestic sources or attract it from abroad, this risk is real.

Slovak businesses have already been hurt by some of the weaknesses affecting enterprises in other Visegrad countries. In efforts to increase market share, Slovak businesses are purchasing in cash but selling on credit on a term basis (over several months and years). This is risky, weakens enterprise liquidity, and raises prospects for bankruptcy over time unless companies can reverse these strains on cash flow. Other general weaknesses hindering enterprise performance are inadequate information systems and weak standards of information disclosure, a limited pool of managers trained to function in a market economy, and weak governance in most enterprises. Some of the governance weaknesses have

Table 23: Pre-Tax Profits and Losses by Economic Sector in Slovakia: 1993

<table>
<thead>
<tr>
<th>Economic Sector</th>
<th>SK</th>
<th>US$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>25.8</td>
<td>777</td>
</tr>
<tr>
<td>Agriculture &amp; Forestry</td>
<td>-6.6</td>
<td>-199</td>
</tr>
<tr>
<td>Mining</td>
<td>0.8</td>
<td>24</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>-0.6</td>
<td>-18</td>
</tr>
<tr>
<td>Food Processing</td>
<td>0.9</td>
<td>27</td>
</tr>
<tr>
<td>Textiles</td>
<td>0.2</td>
<td>6</td>
</tr>
<tr>
<td>Paper, Printing &amp; Publishing</td>
<td>-0.2</td>
<td>-6</td>
</tr>
<tr>
<td>Production of Chemicals and Fibers</td>
<td>1.2</td>
<td>36</td>
</tr>
<tr>
<td>Production of Machinery and Instruments</td>
<td>-3.7</td>
<td>-111</td>
</tr>
<tr>
<td>Electrical and Optical Appliances</td>
<td>-1.0</td>
<td>-30</td>
</tr>
<tr>
<td>Electricity, Gas &amp; Water Supply</td>
<td>26.2</td>
<td>789</td>
</tr>
<tr>
<td>Construction</td>
<td>0.2</td>
<td>6</td>
</tr>
<tr>
<td>Retail Trade, Motor Repair, Consumer Goods</td>
<td>-2.1</td>
<td>-63</td>
</tr>
<tr>
<td>Public Catering and Accommodation</td>
<td>-0.4</td>
<td>-12</td>
</tr>
<tr>
<td>Transport, Storage &amp; Communications</td>
<td>6.3</td>
<td>190</td>
</tr>
<tr>
<td>Other</td>
<td>4.6</td>
<td>139</td>
</tr>
</tbody>
</table>

Source: Slovak Statistical Office (cited from an internal World Bank report).

---

been corrected by the role played by IPFs, but in most cases this has not been sufficient. Meanwhile, enterprise ownership is dispersed. This has entrenched the position of management, which will become more firmly entrenched with the GoS decision to terminate voucher privatization intermediated through IPFs in favor of direct sales (see Section III).

Meanwhile, because of cash flow strains, many enterprises continue to seek central government subsidies. In fiscal 1993, the government provided SK 16 billion in current subsidies and another SK 5 billion in investment subsidies, about half to the agricultural sector and half to industry and transport. Total subsidies amounted to US$ 632 million, or nearly 6 percent of GDP. In addition, the state sector was SK 19 billion in arrears on taxes, equivalent to US$ 572 million, or 5 percent of 1993 GDP. Thus, subsidization and tax arrears accounted for nearly 12 percent of 1993 GDP. This explains much of the net increase in bank lending to GoS (via the purchase of GoS securities) from 1991-1994.

<table>
<thead>
<tr>
<th>Table 24: Number and Share of Registered Private and State Companies in the Slovak Republic</th>
</tr>
</thead>
<tbody>
<tr>
<td>------------------</td>
</tr>
<tr>
<td>Private</td>
</tr>
<tr>
<td>State</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Subsidization and tax relief have put off the use of bankruptcy and liquidation. By end 1993, there were about 175,000 commercial cases pending regarding debt collection and other contract enforcement issues. In addition to subsidies and tax arrears, the selective use of bank lending and National Property Fund guarantees has delayed needed restructuring and liquidation of non-viable businesses. Absent restructuring, there remains a likelihood of increased subsidization and demands for continued tax relief that may have negative fiscal effects over time. If subsidization and tax arrears abate, business failures are likely to surface.

Private Sector Employment and General Unemployment

Private sector employment has increased from 10 percent in 1990 and 28 percent in 1991 to 54 percent in 1994. This trend reflects two key developments: (i) ownership transformation of enterprises resulting from mass privatization; and (ii) the emergence of 300,000-500,000 self-employed "enterprises"

---

269 IPFs have been effective in exercising governance in some cases, enough for managers to feel threatened. However, in many other cases, IPFs have limited capacity to play an active "strategic" role in all firms in which they invest. As a result, they focus their corporate governance on companies which make up the largest portions of their portfolios. Remaining companies are managed in a "portfolio" manner, more passively. It is expected that some companies will do well, and others less well. IPF objectives are to generate favorable aggregate returns from their portfolios. The exercise of corporate governance is allocated based on where it is likely to be most needed to generate the targeted aggregate returns.
by end 1994\textsuperscript{270} (from 200,000 at the end of 1991). Most increases in private sector employment have been in services, notably in trade and repair, construction, manufacturing, real estate, and food and lodging. Private sector employment (mostly self-employment) increased by about 800,000 jobs from 1990 to 1994, while state sector employment declined by more than 1.3 million during the same period. Table 25 shows employment trends in Slovakia by sector and ownership from 1991-1994.\textsuperscript{271}

<table>
<thead>
<tr>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>-------</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
<tr>
<td>Agriculture</td>
</tr>
<tr>
<td>Industry and Power</td>
</tr>
<tr>
<td>Construction</td>
</tr>
<tr>
<td>Trade, Rest's, Hotels</td>
</tr>
<tr>
<td>Transport, Comm's</td>
</tr>
<tr>
<td>Finance, Real Estate</td>
</tr>
<tr>
<td>Social Services</td>
</tr>
<tr>
<td>Other</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
<tr>
<td>State</td>
</tr>
<tr>
<td>Private</td>
</tr>
</tbody>
</table>

*It is unclear why the totals differ.*


As in the other Visegrad countries, the scale of Slovak enterprises has gotten smaller, as uncompetitive heavy industrial firms have released employees. From 1989-1994, manufacturing employment decreased by 24 percent, much of it in the SOE sector. However, despite such declines, state enterprises are still nearly 14 times larger than registered private enterprises in terms of head count. While Slovakia’s private enterprises are now predominantly small-scale or microenterprises, SOEs remain large-scale on average. In 1994, 94 percent of registered firms were privately owned. These enterprises accounted for 54 percent of employment in firms averaging 40 employees. Meanwhile, state enterprises accounted for only 6 percent of total registered enterprises, but employed 553 on average. Table 26 shows the difference in firm size by ownership. Unemployment has clearly increased with layoffs in the industrial SOE sector. Unemployment was

![Table 26: Firm Size of Profile of Slovak Enterprises (1994)](image)

\textsuperscript{270} Officially recognized "non-registered" enterprises approximated 287,000 by end 1994.

\textsuperscript{271} This table omits the decline of about 300,000 state sector jobs and increase of about 250,000 private sector jobs from 1990-1991.
as low as 1.5 percent, or 39,600 in 1990. This figure peaked at 14.4 percent in 1993, or 368,090 unemployed. Most job losses have been made up from self-employment. However, unemployment still totaled 360,000 in 1994, or 14 percent of the work force.

The reliance on self-employment also does not help the government's fiscal position. Many self-employed actually work for other firms, but remain self-employed to avoid paying social insurance taxes. Meanwhile, in early 1993, only 193 of 419 state enterprises held by the Ministry of Economy had paid all their taxes on time. This reflects serious arrears in the SOE sector, which were more than 5 percent of 1993 GDP.

Private Sector Credit

Credit has expanded in the Slovak Republic, with the most dramatic proportional increase going to GoS. Incremental lending to GoS and the private sector have been about even in dollar terms, and there has been a decline in lending to the state enterprise sector. The decrease in lending to the state enterprise sector was prompted by high levels of non-performing loans extended by partly privatized but traditionally state banks to state enterprises. Of total loans outstanding as of August 1993 on the balance sheets of the Slovak Republic's four largest banks, 28 percent of these loans were non-performing. To reach a targeted international standard of 8 percent capital adequacy ratios, this would have required an additional SK 22.6 billion in new equity (US$ 782 million, or 7.3 percent of 1992 GDP). Because of such poor performance, banks have curtailed most lending to the state enterprise sector since 1993, although there was a slight increase in volume in 1994. However, GoS has borrowed from the banks, largely to finance SOE deficits that are no longer passively covered by the banks.

About two-thirds of increased lending to the private sector has been to the ex-state cooperative sector, with little increase in the household or new enterprise sector. In terms of lending flows, banks are lending increasingly to the private sector: 80 percent of 1993 net increases in bank loans went to private sector entities. While Slovak banks are also increasing their purchases of government securities to finance budget deficits (28 percent of total domestic credit), this is happening less than in Hungary and Poland where governments are the main borrowers from banks. Table 27 shows lending trends from 1991-1994, with lending to the SOE sector declining from 59 percent to 33 percent of total. Lending to the private sector increased from 29 percent to 39 percent, about two-thirds of the increase in the former state cooperative sector.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>US$ billions</td>
<td>SK billions</td>
<td>% of Total</td>
<td>US$ billions</td>
</tr>
<tr>
<td>Total</td>
<td>8.4</td>
<td>233.0</td>
<td>100%</td>
<td>10.5</td>
</tr>
<tr>
<td>Government, net</td>
<td>1.0</td>
<td>26.7</td>
<td>12%</td>
<td>2.3</td>
</tr>
<tr>
<td>State Enterprises</td>
<td>5.0</td>
<td>138.0</td>
<td>59%</td>
<td>4.5</td>
</tr>
<tr>
<td>Private Sector*</td>
<td>2.4</td>
<td>68.3</td>
<td>29%</td>
<td>3.7</td>
</tr>
</tbody>
</table>

* Private sector includes cooperatives, households and individuals

Sources: Slovak National Bank; internal World Bank reports.

115
Slovak enterprises receiving credit have benefitted from narrower interest rate spreads. Short-term interest rate spreads declined from 7.67 percent in the second quarter of 1993 to 2.90 percent in early 1994. Part of this reflects the results of a fairly restrictive monetary policy which has maintained stable reserve requirements (9 percent), brought down inflation rates (from 61 percent in 1991 to an average 15.6 percent from 1992-1994), and allowed Treasury bill yields and auction rates to fluctuate based on inflationary expectations.

Notwithstanding a fairly sound macroeconomic environment, considerable structural weaknesses exist at the firm level (see "Private Sector Contribution to GDP" above). Because of the run-up of product inventories (without firm sales orders) and the breakdown of traditional trade relations, inter-enterprise arrears increased significantly in the early 1990s. Once they reached dangerous levels, suppliers began to demand up-front cash or barter, which hurt enterprise liquidity and prompted government intervention. Legislation was enacted to net out inter-enterprise credits of firms held by the Ministry of Economy and National Property Fund. These credits amounted to SK 146 billion (about US$5 billion, half of annual GDP, and about half of total bank credit), of which more than half were overdue. While the Slovak Republic was successful in managing inter-enterprise arrears, many of these enterprises have run up new arrears to trade creditors. These weaknesses reflect the need for additional private investment and restructuring in the state sector to avoid macroeconomic destabilization, and to provide needed liquidity in the marketplace.

**Private Sector Deposits**

The private sector continues to be the main source of deposits, with households and entrepreneurs providing steadily growing shares of deposits to the banking system. While households remain the major depositors in the banking system (about 55-60 percent on a continuous basis), private entrepreneurs are the most dynamic group in terms of deposit mobilization. Meanwhile, deposits from state enterprises and other sectors have declined, reflecting liquidity constraints now that bank credit to SOEs has diminished and inter-enterprise arrears have been partly curtailed.

Unlike in other countries where bank lending is constrained (Hungary, Poland), small-scale entrepreneurs are able to borrow from the banking system. This provides an incentive for them to place

---

272 Fizako, a private company, was appointed to sort out inter-enterprise arrears. Fizako first organized regular rounds for enterprises to present receivables exceeding SK 10,000, which became compulsory in late 1993. Fizako then matched receivables data with payables claims. This clearing exercise led to the identification of loss-making enterprises, and those with net current liabilities responsible for slowing down the payment cycle. In the first year, Fizako cleared SK 10 billion out of an estimated SK 80-90 billion in overdue receivables. An additional SK 50 billion were cleared by early 1994. Most arrears were (i) cross-border overdues, in which Slovak SOEs owed Czech enterprises SK 35 billion at end 1992 (of which 73 percent were overdue by April 1993); (ii) claims on CMEA enterprises; and (iii) claims on countries on which arms embargoes were placed.
their deposits with banks, as they have increasingly since 1991. Borrow-back ratios (loans-to-deposits) for private entrepreneurs have improved from 1991-1994, rising from 0.57 to 1.01. Meanwhile, these ratios have remained high in the state enterprise sector (more than 5.0 in 1991 and 4.6 in 1994). In general, the Slovaks have a comparatively high financial intermediation rate at 55 percent (broad money as a percent of GDP), suggesting households and entrepreneurs have confidence in the stability of the banking system.

**Private Sector and Foreign Investment**

The Slovak Republic has experienced declines in fixed investment in recent years. Fixed investment rates have dropped as a percent of GDP from 35 percent in 1991 to 17 percent in 1994. The amount of investment needed to retool and restructure the industrial sector is higher than what is being invested. One of the reasons is because of Slovakia’s poor performance in attracting foreign direct investment. Since 1992, the Slovaks have attracted only US$ 340 million, or 1 percent of GDP. This is similar on a relative basis to Poland, which has attracted less foreign investment than the smaller economies of the Czech Republic and Hungary. While the Slovaks are on record as supportive of private and foreign investment and have achieved some notable successes,

273 their performance has generally been weak. Notwithstanding tax holidays which do not seem to have worked, the inability to attract greater investment has largely been due to political instability, reversals and delays in privatization, and perceptions of uneven playing fields reinforced by government willingness to subsidize state enterprises.

**Private Sector Share of International Trade**

From official statistics, it is difficult to determine private sector share of international trade. Nevertheless, given the increasing prominence of the private sector in the economy, it is likely that the private sector is also gaining prominence in international trade. Correlating private sector GDP with total trade, the private sector likely accounted for US$ 9.7 billion in 1994 compared to US$ 3.8 billion in 1991, a 2.5 times increase.

Since 1991, the Slovak Republic has shown a reorientation of trade patterns without a major change in trade value (although trade values have increased in 1995). While imports from former planned economies have remained a consistent 25 percent of total, Slovak exports to these countries have steadily declined from 20 percent in 1991 to 6 percent in 1994. This would approximate a decline in exports from US$ 1.4 billion in 1992 to only US$ 0.5 billion in 1994, and cumulative exports of US$ 2.65 billion for the three years against imports of US$ 6 billion. It is unclear if such a trade imbalance is designed to pay down arrears to ex-CMEA trading partners, or if certain exports are unrecorded. By contrast, trade with the EU has increased significantly. Exports to EU countries have risen from 16 percent in 1991 to 40 percent in 1994, with cumulative 1992-1994 exports about US$ 7.5 billion (three times exports to CMEA countries). Meanwhile, imports from the EU have increased from 10 percent of total

273 The top 10 foreign investors in the Slovak Republic by country, level of investment (US$), and sector of activity are: (i) K-Mart (US, $65 million, retail); (ii) Volkswagen (Germany, $59 million, automotive); (iii) Rhône-Poulenc (France, $27 million, chemicals); (iv) Novacky Chemieczke Zavody (Czech, $27 million, chemicals); (v) Tatransky Permon (Czech, $17 million, tools); (vi) Degussa (Germany, $13 million, pharmaceuticals); (vii) Henkel-Palma (Austrian, $12 million, detergents); (viii) Mohnlycke (Swedish, $11 million, health/hygiene); (ix) Samsung (Korea, $11 million, refrigerators); and (x) Pepsico (US, $10 million, beverages). See Business Central Europe, May 1995.
imports in 1991 to 26 percent in 1994, with cumulative 1992-1994 imports approximating US$ 5.5 billion. Thus, the Slovak Republic is running trade surpluses with the EU, while running up deficits with the former centrally planned economies. Given such a reorientation in trade with the EU, it is very likely that private enterprises that have been restructured are capturing new markets in the automotive sector, electrical capacitors, footwear, building materials and a range of other products.\textsuperscript{274} Most trade remains outside the EU and centrally planned economies (and largely with the Czech Republic), although the EU has clearly become the fastest growing market for exports and source of imports. The following table profiles international trade patterns for the Slovak Republic in recent years.

<table>
<thead>
<tr>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Total Exported Goods &amp; Services*</td>
</tr>
<tr>
<td>1991</td>
</tr>
<tr>
<td>o/w Former Planned Economies</td>
</tr>
<tr>
<td>o/w EU</td>
</tr>
<tr>
<td>o/w Other</td>
</tr>
<tr>
<td>Total Imported Goods &amp; Services*</td>
</tr>
<tr>
<td>o/w Former Planned Economies</td>
</tr>
<tr>
<td>o/w EU</td>
</tr>
<tr>
<td>o/w Other</td>
</tr>
<tr>
<td>Trade Balance</td>
</tr>
<tr>
<td>w/Former Planned Economies</td>
</tr>
<tr>
<td>w/EU</td>
</tr>
<tr>
<td>w/Other</td>
</tr>
</tbody>
</table>

* 1991 totals are for merchandise only; non-factor services not included

Source: Internal World Bank reports; IMF.

V. CONCLUSION

On the road to global competitiveness over the coming years, the private sector will constitute the essential engine of growth in the Visegrad countries. For the private sector to fulfill this central role, three necessary conditions need to be achieved: (i) the enabling environment needs to be strengthened to make it more conducive to private sector development; (ii) privatization must be accelerated to stimulate competition and complete the systemic change required for sustainable growth; and (iii) investment into the private sector must increase, both through enhanced intermediation by the domestic financial sector and by attracting higher levels of foreign direct investment.

A. Strengthening the Enabling Environment for Private Sector Development

1. Strengthening Property Rights

- **Civil Codes need to be clarified and updated to protect property rights.** Civil Codes date back to 1963-1964 in all four countries, with more recent amendments adopted to modernize codes based on changing property relations. However, the use of mortgages for collateral is still limited in the Czech and Slovak Republics and cumbersome in Poland, weakening investment. Hungary likewise needs to clarify and strengthen property rights, although housing and other properties are more easily mortgaged and collateralized than in the other Visegrad countries.

- **Land and property registries need to be updated, centralized and automated to prevent multiple pledges/liens on the same property.** Property transfers associated with (i) nationalization of agricultural land, and the subsequent privatization of agricultural cooperatives (Hungary), and (ii) to/among central and municipal governments (Poland, Czech and Slovak Republics) have not all been properly recorded. In Hungary and Poland, disparate registries have led to incomplete recordings of property transactions. In Poland, the use of multiple liens on the same property creates creditor uncertainty, reduces secured lending from bank and trade sources, and adds to the cost of credit when provided. Restitution claims also need to be recorded once the status of these claims is resolved. Centralization and automation (currently underway in Poland) will provide a more unified framework for the registration of property, mortgages and collateral. This should stimulate investment, reduce foreclosure costs, and accelerate the resolution of disputes.

- **Overly protective tenancy laws need to be reversed to provide incentives for investment.** In all four countries, rent controls and tight restrictions on eviction reduce investment into properties. This has created a shortage of space for business premises, and driven up costs. In some cases (Hungary, Czech and Slovak Republics), alternative housing must be found for tenants before eviction.

2. Easing Business Registration

- **Business registration must be made easier by reducing the number of visits, time spent, paperwork required, and inconsistent interpretations of licensing/permit requirements.** Improvements have been made, but nearly two-thirds of newly established firms in the Czech Republic, Hungary and the Slovak Republic need up to six months to register their businesses. This is too long, and slows business development.
3. Improving Contract Enforcement

- **Commercial Codes need to be updated to provide more suitable guidance for contract enforcement and settlement of disputes in accordance with principles of market economies.** Updating the Commercial Code is particularly needed in Poland, which uses its 1934 Commercial Code along with more recent amendments.

- **Court capacity needs to be strengthened to adjudicate disputes fairly and quickly.** The Visegrad countries face significant backlog in the court system, slowing down litigation and arbitration. Judges and bailiffs are often inexperienced, court procedures are slow, and private liquidation has only developed in Hungary because of its heavy use of court procedures for bankruptcy and liquidation. Slow processes undermine creditor recourse to contract enforcement, stifling lending and investment. Particular focus should be placed on improving staffing (judges, qualified bailiffs), and providing better compensation and training.

- **Out-of-court procedures need to be developed.** Only in Poland have time-bound procedures been introduced. This can be done elsewhere and expanded in Poland by (i) simplifying administrative procedures; (ii) increasing training and exposure of judges to commercial law; (iii) establishing rules for fair credit reporting and ratings; (iv) encouraging non-bank financial institutions (factoring and liquidation companies) to play a greater role in debt disputes; and (v) placing time limits for resolution of disputes (binding arbitration). In Hungary, contract enforcement has been severely undermined by interference from line ministries and state agencies in the restructuring negotiations of troubled state-owned debtors, although this stopped in June 1995.

- **The use of market mechanisms for contract enforcement, particularly secondary debt markets, should be encouraged.** By discounting and selling debt, creditors would be able to resolve contract disputes (albeit at a loss) without having to experience long and costly delays. While the discount would represent a loss relative to original credit values, holding non-performing loans only weakens the financial condition of the creditor. Furthermore, pursuing more formal procedures is often more costly than the discount that would be assigned to disputed debt in a more fully developed market. This option is strongly recommended for the Czech and Slovak Republics, where as much as 25-30 percent of major banks' loan portfolios are non-performing and bankruptcy procedures are undeveloped. In Poland, secondary debt markets are slowly beginning to emerge now that banks can expense losses. Such market development should be encouraged, particularly now that bank supervision has been strengthened and the central bank has called for higher levels of bank capital. Hungary would also benefit from secondary debt market development, given high levels of non-performing loans at state banks and overutilized court capacity.

4. Improving Bankruptcy and Liquidation Procedures

- **Bankruptcy and liquidation procedures need to be used more frequently as a tool for corporate reorganization, to resolve debt disputes, and to impart financial discipline on borrowers.** This requires further development of commercial law and judicial capacity. The Czech and Slovak Republics have been especially reticent in their use of bankruptcy as a tool for corporate reorganization, largely due to cost, uncertainty of results, and the focus on company liquidation. The Slovak Republic goes as far as to exempt state-owned enterprises from the Bankruptcy Law, creating serious problems of corporate governance. With high levels of non-performing loans among the largest banks, strengthened bankruptcy
procedures are needed to induce enterprise restructuring in Poland and the Czech and Slovak Republics.

- **Reorganization agreements should only require majority support based on debt value, and not require unanimity among all creditors.** This was true in the case of Poland, where a simple majority of creditors representing more than half of aggregate credit are required to agree on reorganization plans. Hungary has recently changed legislation that required 100 percent approval among creditors to two-thirds of debt value and half of claimants. By contrast, the Slovak Republic follows inefficient practices that hinder reorganization agreements (one vote per creditor without regard for individual credit exposure, limitations on foreign creditor participation in resolution proceedings). In the Czech Republic, the focus is on liquidation rather than reorganization. However, if bankruptcy becomes more widely used, reorganization plans should only require majority support. This would accelerate what is currently a very slow process.

- **Restrictions should be in place on the number of appeals that can be filed once reorganization and liquidation plans are established.** In Hungary, successive appeals have often led to delays, which permitted asset stripping and delayed restructuring. More recent changes are intended to correct this.

5. Improving the Workings of Labor Markets

- **Businesses need more flexibility in hiring new employees and firing unneeded personnel.** The Visegrad countries have already shown substantial flexibility with regard to hiring and compensation, as shown by the proliferation of owner-operated firms, significant use of sub-contracting, and size of the informal sector. Nevertheless, in the larger enterprises where ownership is still often in the hands of the state and where work rules are more formalized, flexibility has been less evident. Compensation issues represent operating costs and productivity measures to enterprises, and are better dealt with through boards, managers and employees based on enterprise performance.

- **Social insurance costs need to come down as part of the incentive to companies to hire new employees.** Especially in Hungary and Poland, the social insurance burden placed on formal enterprises adds to their operating costs and provides a disincentive to hire new workers. In these two countries, social insurance costs (social security, health, unemployment compensation) add an additional 50 percent to wage/salary costs of employers, while adding about 40 percent in the Czech and Slovak Republics. Until this burden declines, companies will be reluctant to formally hire employees. Placing greater responsibility on individuals for long-term savings and encouraging the development of private pension plans would help reduce public expenditure requirements, and therefore allow an easing of payroll tax rates.

6. Enhancing Financial Sector Capacity

- **Commercial bank privatization should be accelerated to increase competition in the financial sector and adhere to EU Association Agreements.** While all four Visegrad countries have opened their banking markets, state-owned and recently privatized state banks continue to hold about three-quarters of balance sheet values. Such concentration, combined with many of these banks’ earlier specializations (savings, foreign exchange, housing, agriculture, state enterprise sector) have perpetuated fragmented and inefficient markets. In the Czech and Slovak Republics the priority is to remove blocking shares of the governments in the largest banks to accelerate needed bank restructuring. In Poland, critical actions include (i) accelerating the privatization of regional SOCBs to meet targets of its enterprise and bank
restructuring program; and (ii) accelerating the restructuring of its specialized banks in advance of privatization. In Hungary, priority actions include (i) privatizing large state banks as quickly as possible, or separating them into good and bad banks, privatizing the good and liquidating the bad; and (ii) privatizing smaller banks quickly, or proceeding with their liquidation if privatization is not feasible.

- **Bank supervision and prudential regulations need to reflect risk on a long-term basis, rather than strictly on immediate or near-term conditions.** All four Visegrad countries have improved their accounting standards, strengthened on-site supervision and off-site surveillance, and reduced subsidies to troubled banks. Nevertheless, many banks are still not adequately provisioning for loan losses, largely because they underestimate the medium-term risk of many businesses to repay and service existing loans. Combined with high levels of non-performing loans, these issues are particularly important given the "universal" character of Visegrad banks (except Hungary), the cross-ownership between banks and other financial institutions and enterprises (primarily Czech and Slovak Republics), and the continued risk of government subsidies to prop up major banks (all four countries).

- **Capital markets development needs to accelerate.** In general, capital markets development has been slow in the Visegrad countries, apart from the Czech Republic where hundreds of Investment Privatization Funds, an open climate for foreign investment, and mass privatization have stimulated rapid stock exchange development. Even still, the Czech Republic’s stock market capitalization is only about 35 percent of GDP. The other three countries are far below this figure, with Hungary and Poland only at about 4 percent. Bond markets have also been slow to develop. In both stock and bond markets, daily turnover is low. Capital markets development in all four countries will require (i) accelerating share transaction settlements; (ii) improving the collection and transmission of data; (iii) imposing stricter information disclosure standards; (iv) speeding up the flotation and valuation process; and (v) removing tax preferences for government securities compared to corporate securities. Accelerated privatization in Hungary, Poland and the Slovak Republic would provide a needed stimulus, as shown in Poland with the mass privatization of about 500 firms expected to double the market capitalization of the Warsaw Stock Exchange in 1996.

7. Easing the Tax and Social Insurance Burden

- **All four Visegrad countries need to reduce tax rates.** Current rates are consistent with European standards, but are high by global standards. In the Visegrad countries, corporate tax rates are 45-50 percent (aside from Hungary), and personal income tax rates are 15-47 percent. Visegrad countries also impose high sales taxes (as high as 25 percent), and onerous social insurance contributions (as high as 45-50 percent). High tax rates are a major reason for high levels of informal sector activity (including tax evasion) in Hungary and Poland. Hungary and Poland especially need to introduce pension and health reforms which help to reduce payroll taxes borne by the enterprise sector.

- **Tax regimes need to be simplified.** Hungary and Poland in particular have a long list of exemptions and differing rates because tax rates are so high. The elimination of uneven tax treatment would promote market development, reduce unaffordable government subsidies, limit the premature call on future social insurance benefits, simplify tax administration, and lower tax rates without undermining revenue collection. This is of particular importance to Hungary and Poland, given large fiscal deficits (Hungary), high levels of debt (Hungary), and costly social insurance programs (both countries).
B. Accelerating Privatization

- The Visegrad countries should accelerate the privatization of enterprises. Only the Czech Republic has pursued accelerated privatization, although several large enterprises are still partially owned by the government. The Czech Republic should move to close out its remaining holdings where privatization has already partly occurred. With enactment of the new Privatization Law in May 1995, Hungary is moving in the right direction with plans to divest most remaining state assets by 1997. By contrast, Poland’s recently archived Law on Commercialization and Privatization threatened to maintain state interference in the economy. With about 4,500 state enterprises (net of those being mass privatized), Poland should develop a timetable for privatization, as has recently occurred in Hungary. It should also accelerate the privatization of many blue chip infrastructure companies, and pursue total rather than partial privatization transactions. The Slovak Republic’s recent cancellation of mass privatization and preference for politically-motivated management buyouts is retrogressive and sends out poor market signals. GoS should restore plans to mass privatize, and accelerate the privatization of companies held by the state and NPF to attract investment and needed restructuring resources. GoS should also change bankruptcy legislation exempting SOEs, as these are generally in need of serious restructuring.

- Privatization should be managed and packaged as a market signal. The Czech Republic has used its accelerated privatization program to spur needed investment flows and convey an image of open competition. However, the other three Visegrad countries have created enough obstacles in the past to raise doubts among investors. The Slovak Republic’s recent reversal of mass privatization, limitations imposed on IPFs, and questionable management buyouts (Slovnaft) undermine investment. GoH reversal in early 1995 of the HungarHotel privatization after receiving competitive bids raised doubts (for a while) in the investment community about privatization prospects in Hungary. Poland’s traditionally slow approach to privatization, and more recent efforts by parliament to increase GoP involvement in the privatization process, likewise send out signals questioning the country’s commitment to privatization.

C. Increasing Investment in the Private Sector

1. Domestic Financial Institutions

- Visegrad banks will have to significantly reduce operational inefficiencies and internal financial weaknesses to become more efficient intermediaries. As non-performing loans have emerged during periods of economic growth and after major bank recapitalizations in all four countries, it is clear that banks are often unable to make sound credit judgments. Changes will require (i) improved loan management and credit risk evaluation skills; and (ii) better processing, and improved financial and cost accounting and management information systems; and (iii) increased capital to provide adequate cushioning for loan losses. Visegrad country banks will also need increased exposure to non-credit services to improve service delivery. Hungary’s foreign and prime-rated banks are providing the local market with superior trade finance and bond underwriting skills, resulting in superior profitability despite smaller asset bases. Domestic banks in all four countries will need to compete at these levels to maintain traditional clients and increase market share in fee-generating activities.

- Private sector companies in all four countries will also need to change their capital structures (debt-equity ratios) to obtain needed investment financing (debt and equity) and working capital from banks and other creditors. Enterprises in Visegrad countries often take profits out of their companies to limit tax payments, rather than retaining profits as growing companies should. This keeps companies
undercapitalized, limits investment (and collateral), and reduces chances of obtaining bank loans. Accelerated development of capital markets and non-bank financial institutions is needed to alter capital structures. All four countries need to strengthen collateral laws and property rights to increase the number of leasing companies. All four countries would increase low daily turnovers in the stock and bond markets with (i) a commitment to accelerated privatization (Hungary, Poland, Slovakia); (ii) increased investment opportunities; and (iii) a reduced tax and social insurance burden on the enterprise sector (particularly Hungary and Poland).

2. Foreign Direct Investment

To attract foreign investment, the Visegrad countries need to present an image that worthwhile market opportunities abound, and that returns will not only exceed the risk but will exceed the returns found elsewhere in the global economy. Hungary and the Czech Republic have attracted significant foreign investment, and are now at the stage where their blue chip enterprises should generate significant proceeds. What is common to these two countries, and not common to Poland and the Slovak Republic, is an image of open competition and fair treatment to foreign investors. Hungary has been the best performer with regard to foreign direct investment, largely because of its open economy and notwithstanding slow privatization, macroeconomic imbalances, and periodic reversals of privatization decisions (HungarHotel in 1995). Much of Hungary's FDI has been in the infrastructure sector, where private participation has been actively solicited. Its commitment to accelerated privatization through 1997 should generate significant incremental FDI in the infrastructure sector. The Czech Republic has equalized the treatment of domestic and foreign investment in its Commercial Code, and generally observed these principles. A demonstrated commitment to accelerated privatization has also attracted significant foreign investment. This should continue as the Czech Republic proceeds with key blue chip privatizations in the coming years. By contrast, Poland and the Slovak Republic have failed to attract much FDI, although Poland is now showing improvement. Poland's efforts to attract FDI have been weakened by slow privatization, frequent government turnover, restrictions on land purchases, and slow capital markets development. Recently passed legislation in 1995 may also delay FDI in key infrastructure sectors (telecommunications, electricity, gas, airlines). However, with high real growth rates and favorable bond ratings, foreign investment is now starting to flow. The Slovak Republic has fared poorly in attracting FDI because of the lack of reliable information, uncertainties and subsequent cancellation of mass privatization, GoS preference for management buyouts, uncertainty about contract enforcement, and earlier problems with currency conversion. The Slovak Republic will have to reverse these weaknesses, and commit itself to more transparent procedures (open tenders) in the privatization of blue chip enterprises if it is to attract FDI.
ANNEX 1

LEGAL, REGULATORY AND INSTITUTIONAL DESCRIPTIONS

Box 1: Corporate Structure and Governance in the Visegrad Countries
Box 2: Patent Protection, Trademarks, and Intellectual Property Rights in Visegrad Countries
Box 3: Restitution in the Visegrad Countries
Box 4: Legal, Regulatory, and Institutional Weaknesses and Recommendations
Box 1: Corporate Structure and Governance in the Visegrad Countries

General Summary: There are three general sets of companies in the Visegrad countries apart from owner-operated firms: (i) joint-stock companies; (ii) limited liability companies; and (iii) partnerships. Joint-stock companies are comparatively large, with broad ownership, more extensive reporting requirements, minimum capital requirements ranging from US$ 30,000 in the Slovak Republic to US$ 70,000 in Hungary. This is comparable to EU ranges of US$ 17,000-127,000. Joint-stock companies generally have a Board of Directors and a Supervisory Board. The Board of Directors is elected at the general (annual) meeting. Supervisory Boards in firms with greater than 50-200 employees usually elect one third of their members by employees, and two-thirds by shareholders. Limited liability companies are often small- or medium-scale enterprises (SMEs) with minimum capital of US$ 1,600 in Poland to US$ 7,000 in Hungary. In EU countries, the average is US$ 20,000. Limited liability companies are usually managed by at least one "statutory representative" appointed by the general meeting. All countries have partnerships with (i) unlimited (joint and several) liability, which evenly distributes obligations and benefits; and (ii) "unlimited liability" for managing partners plus "limited liability" for others based on capital contribution. Partnerships are generally governed on the basis of capital contribution and potential liability concerns.

Czech Republic: Joint-stock companies have minimum capital requirements of K 1 million (about US$ 35,000), and a capital reserve fund (retained earnings) of 10 per cent of capital supplemental each year from at least five per cent of net profits until reaching 20 percent of total capital stock. This makes them comparatively small but well-capitalized among Visegrad countries. The Board of Directors is elected at the general (annual) meeting. Supervisory Boards in firms with greater than 50 employees must elect one third of their members by employees, and two-thirds by shareholders. Limited liability companies have minimum capital of K 100,000 (US$ 3,500).

Hungary: In 1984, Hungary adopted an amendment to the Company Law which introduced the concept of the self-managed enterprise. Within a few years, 80 per cent of state enterprises became self-managed. Subsequent changes in the Commercial Code in 1988 addressed new companies and the "corporatization" of SOEs. As in the other Visegrad countries, this included the introduction of new corporate forms: (i) joint-stock companies; (ii) limited liability companies; and (iii) partnerships. Joint stock companies are required to have minimum capital of HUF 10 million (US$ 70,000), of which at least 30 per cent must be paid at registration. Preferred shares are allowed, but can not be greater than 50 per cent of total share capital. Convertible bonds and preference bonds are allowed to increase equity, and workers' shares can be granted at below market rates, but can not constitute more than 10 per cent of registered capital. Joint-stock companies are required to have three layers of internal supervision (executive officers, Board of Directors, Supervisory Board) plus an external auditor. Firms have at least three Supervisory Board members if capital exceeds HUF 20 million (US$ 140,000) and average head count exceeds 200. An independent auditor is required if capital exceeds HUF 80 million (US$ 550,000). Management is appointed for up to five years, but can be reappointed. Depending on firm size and complexity, the Board of Directors has three to 11 members, with conflict of interest provisions intended to improve governance. The Supervisory Board has three to 15 members, of which one third must be elected by employees if the company has more than an annual average of 200 employees. Limited liability companies are required to have minimum capital of HUF 1 million (US$ 7,000), and must be managed by at least one director. Partnerships are found in two forms (as in the Czech and Slovak Republics) in accordance with prevailing Commercial Law: general partnerships, which share joint and several liability; and limited partnerships, in which management has unlimited liability, while other partners have liability restricted to the amount of their investment.

Poland: Poland's Company Law allows for joint-stock companies, limited liability companies, and three different kinds of partnerships. Joint stock companies must have at least three founders (with the exception of commercialized companies owned by the state Treasury), and minimum capital of OP 1 billion (US$ 40,000). Financial disclosure must be made to the Court of Registration as well as the appropriate Ministry, usually the Ministry of Finance or Ministry of Industry and Trade. Joint stock companies are not permitted to have non-voting or interest-bearing shares, limiting the use of subordinated debt or preferred stock features in the capital structure of firms. Articles of incorporation can restrict the voting power of large shareholders to prevent excess concentration of shareholder decision-making power. Limited liability firms must have minimum capital of OP 40 million (US$ 1,500). Shareholders in these firms are free to determine profit distribution, voting rights, and management and board members. The three partnerships are (i) registered partnerships with unlimited, joint and several liability; (ii) limited partnerships, with standard provisions limiting liability for limited partners and assigning unlimited liability to general partners, but with a tax pass-through similar to US Sub-chapter S firms in which profits are taxed at the personal income tax rate; and (iii) civil partnerships, in which partners have equal values and share distributions, and property is not divisible. The first two partnerships are established in accordance with provisions of the Commercial Code, while the third partnership is based on contractual agreements and the Civil Code. Most companies initially incorporate as partnerships or simple owner-operated firms to avoid double taxation at corporate and individual levels, although they may incorporate as joint-stock or limited liability firms as they grow to contain liability.

Slovak Republic: As in the other Visegrad countries, corporate structure is generally in the form of joint-stock companies, limited liability companies, and partnerships. Much like the Czech Republic, Slovak joint-stock companies have minimum capital requirements of SK 1 million (about US$ 30,000). The Board of Directors is elected at the general (annual) meeting. Supervisory Boards in firms with greater than 30 employees must elect one third of their members by employees, and two-thirds by shareholders. Limited liability companies have minimum capital of SK 100,000 (US$ 3,000). There are two standard types of partnerships in the Slovak Republic. As in the Czech Republic (and soon in Poland), Investment Privatization Funds (IPFs) own a significant number of enterprises resulting from the first wave of privatization in the CSFR. Their objective is to maximize shareholder value, which clearly impacts corporate governance. IPFs are unnecessarily constrained in their investments, as they cannot have more than 20 percent ownership in a firm (according to Act 248). Corporate governance among large SOEs is complicated by the National Property Fund (NPF), which serves as trustee for more than 500 SOEs. While the NPF has served as a passive board member or investor, it is vulnerable to political preferences, and in no position to help with management or governance in an active way. It only had staff of 65 in 1993, focused on privatization processing rather than corporate restructuring.

Sources: C. Gray, "Evolving Legal Frameworks for Private Sector Development in Central and Eastern Europe"; internal World Bank reports; Oxford Analytics; "International Business Practices", University of Missouri-St. Louis; "Investment in Poland", KPMG; EU embassies.
Box 2: Patent Protection, Trademarks, and Intellectual Property Rights in Visegrad Countries

**Summary Comparison:** The Visegrad countries observe international agreements governing intellectual property rights. The Czech Republic and Hungary have attracted high levels of foreign investment in recent years, indicating that intellectual property rights are generally not a barrier to investment in these countries. Other reasons are cited for the low investment levels in Poland and the Slovak Republic. However, some investment may be held up (pharmaceuticals in Hungary) where processes are patent-protected but products are not.

<table>
<thead>
<tr>
<th><strong>Czech and Slovak Republics:</strong> The CSFR passed a new trademark law (1988), with amendments (1990) on patent and copyright laws. These laws are viewed as consistent with international standards. Patents are for 20 years, and apply to technology with judicial reviews. Excluded are theories, mathematical methods, superficial product changes, medicines and foodstuffs. Copyrights apply to computer programs and data bases, audio-visual and sound recordings. Protection is for the life of the author plus 50 years. Trademarks are licensed for 10 years and are renewable. The Czech and Slovak Republics cooperate with international organizations and observe international conventions. However, weaknesses exist in enforcement capacity.</th>
<th><strong>Hungary:</strong> Patents are for 20 years for processes. Copyrights are for the life of the author plus 50 years. Trademarks are licensed for 10 years and are renewable.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Poland:</strong> Poland is a signatory to international agreements, and a member of the World Intellectual Property Organization. Patent protection is for 15-20 years, and according to law covers pharmaceuticals, foodstuffs, chemical products and other areas. Trademarks are protected for 10 years and are renewable.</td>
<td></td>
</tr>
</tbody>
</table>

**Sources:** C. Gray, "Evolving Legal Frameworks for Private Sector Development in Central and Eastern Europe"; internal World Bank reports; Oxford Analytica; "International Business Practices", University of Missouri-St. Louis.
### Box 3: Restitution in the Visegrad Countries

**Czech Republic:** Restitution has been used as a method of repatriization to previous owners and privatization for new owners. Restitution has served as a stimulus for the development of a property rental market, although serious distortions still exist in that market. The Czech Republic has passed four restitution laws: (i) apartments and small businesses, with 70,000 properties transferred by 4/1/91; (ii) companies nationalized with financial restitution (vouchers) in lieu of property transfers, involving five percent of all state property transferred by 10/1/91; (iii) agriculture and forests, with 3.5 million title holders having received property by 12/31/92; and (iv) land confiscated from ethnic Germans and Hungarians after 1949 on the condition that they stayed in Czechoslovakia and regained Czech citizenship. As in the Slovak Republic, limits are placed on financial compensation via restitution of K 60,000 (about US$ 2,000), of which half can be provided in cash and the other half in bonds.

**Hungary:** The Civil Code guarantees "adequate compensation" for property expropriated for the public interest. In 1991, compensation was made for property expropriated after 1939 via transferable, interest-bearing coupons (in lump sum, with a maximum payment HUF 5 million) that could be used for the privatization of apartments, farmland (only to former land owners), and the purchase of shares in privatizing SOEs. As a result of this program, Hungary paid out about HUF 100 billion (then US$ 1.3 billion), or four percent of 1991 GDP. About half the vouchers were used for land privatization. By 1993, 400,000 of a total 1.5 million compensation and restitution claims had been settled.

**Slovak Republic:** Restitution has been used for some privatization of small enterprises to the original owners. About one third of privatized shops (more than 3,000) were returned to the original owners during the first wave of privatization. The NPF has some restitution shares in its portfolio. Restitution has also been used to a limited degree for the "privatization" of bank shares (three percent of VUB and Investcna). Financial compensation is provided for up to SK 60,000 (about US$ 2,000), half in cash and half in bonds, when properties cannot be transferred to meet restitution claims.

**Poland:** Restitution has not been dealt with resolutely in Poland. Previous owners have been offered coupons (5% of shares), but this has not succeeded in resolving claims. Only 5,151 applications for restitution of national property were filed from 1991-1994, although potential claims of 500,000 (nearly one third from abroad) valued at about US$ 15 billion serve as an impediment to privatization. Restitution has had two negative effects: (i) delaying privatization transactions; and (ii) constraining asset growth for collateralized lending, hence reducing credit flows to private enterprises. There is no restitution law, leaving the process open to ad hoc political approaches which add to uncertainty about property values. This slows privatization and overall private sector growth.

Sources: C. Gray, "Evolving Legal Frameworks for Private Sector Development in Central and Eastern Europe"; "Slovakia: Restructuring for Recovery", World Bank; internal World Bank reports; "International Business Practices", University of Missouri-St. Louis; Polish Ministry of Privatization.

---

1 This remains a sensitive diplomatic issue between the Czech Republic and Germany, with "Sudeten Germans" living in Germany seeking restitution and/or compensation. Such a dispute may not factor into the Czech Republic's ambition to become an EU member, but it does represent a risk.

2 Draft restitution laws are being discussed, and some claims have been settled on a case-by-case basis.
<table>
<thead>
<tr>
<th>Weaknesses</th>
<th>Recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inadequate Collateral Laws, inadequate property registries, and unclear title to property undermine the use of collateral for secured transactions and limit investment.</td>
<td>Laws and registries need to be clarified and updated to stimulate the use of collateral for transactions based on transparent legal guidelines, principles of contract enforcement, market-based valuations and timely liquidation.</td>
</tr>
<tr>
<td>High levels of taxation place a heavy burden on businesses, prompting higher levels of tax avoidance.</td>
<td>Visegrad tax rates (VAT, personal, corporate, social insurance) will have to decline to be in line with standards of global competitiveness. This will require a redefinition of the role of the state, and be based on lower levels of public expenditure as a share of GDP.</td>
</tr>
<tr>
<td>Lack of bank recourse in enforcing contracts regarding secured lending, weakening loan recovery rates and reducing bank incentives to provide loans.</td>
<td>Clarifying property rights and having the required legal infrastructure is central to enforcing contracts. Until these issues are solved, capital will remain seriously constrained, and with it economic growth.</td>
</tr>
<tr>
<td>Outdated approaches to anti-monopoly that have not been effective in breaking up state monopolies, and carry the potential for public sector abuse of market transactions (pricing, transactions).</td>
<td>Visegrad countries will benefit most from open trade and investment practices, less discretionary power in the hands of regulators, and the development of market-based institutions (stock exchanges, rating agencies) to prompt more open competition and information disclosure.</td>
</tr>
<tr>
<td>Inconsistent treatment of licensing standards, and sometimes unnecessarily complex registration procedures limit formal sector business formation. Perverse incentives to limit start-up capital sometimes undermine new business competitiveness.</td>
<td>Simplicity, &quot;one-stop shopping&quot;, low and fixed registration fees, and lower tax rates will increase formal registration and expand the fiscal base.</td>
</tr>
<tr>
<td>Court capacity for bankruptcy and liquidation has been strained or burdened by delays. Out-of-court methods have generally not developed as much as needed. In some cases, high levels of resistance to the use of bankruptcy and liquidation have delayed needed bank and enterprise restructuring.</td>
<td>Clarification of property rights, more active contract enforcement, and the training of judges, lawyers and others (for simple civil cases) in commercial law and practices will help resolve disputes and stimulate competition.</td>
</tr>
<tr>
<td>In some cases, foreign investment has run up against protectionist barriers, or been deterred by slow privatization, frequent political turnover, and government meddling in privatization transactions after the fact.</td>
<td>Active promotion, fair treatment, political (and legal and regulatory) stability, accelerated privatization, capital markets development, and transparency will increase foreign investment.</td>
</tr>
</tbody>
</table>
### CZECH AND SLOVAK REPUBLICS: Political Changes Since 1990

**1990**
- **President**: Vaclav HAVEL
- **Prime Minister**: Marian CALFA
- Federal government of Czechoslovakia formed by coalition of Communist Party, previously allied parties and independents
- **Main Political Parties**: Revival; Czechoslovak Communist Party; Christian Democratic Party; Czechoslovak Socialist Party; Green Alternative Party; Czechoslovak Farmers' Party; Czechoslovak Social Democratic Party; Czechoslovak Democratic Initiative

**June 1990**
- **Main Political Parties/Alliances**: Civic Forum (CF) in the Czech lands; Public Against Violence (PAV) in Slovakia; Czechoslovak Communist Party (CSCP); Christian Democratic Union/Movement (CDU/CDM); Society for Self-Governing Democracy in Moravia and Silesia; Slovak National Party; Coexistence/Hungarian Democratic Movement

**February 1992**
- **New government under the coalition of Civic Forum** (split into the Civil Democratic Party, Civic Democratic Alliance and the Civic Movement) and Public Against Violence. **Prime Minister**: Marian CALFA
- **Main Political Parties/Alliances**: Civic Forum (CF) in the Czech lands; Public Against Violence (PAV) in Slovakia; Czechoslovak Communist Party (CSCP); Christian Democratic Union/Movement (CDU/CDM); Society for Self-Governing Democracy in Moravia and Silesia; Slovak National Party; Coexistence/Hungarian Democratic Movement

**June 1992**
- **General elections lead to a new federal government under the coalition of the Civic Democratic Party, the Movement for Democratic Slovakia, and the People's Party.** **Prime Minister**: Jan STRASKY

**January 1993**
- **Split of Czechoslovakia into two Republics: the Czech Republic and Slovakia.**
- **Czech Republic**:
  - **President**: Vaclav HAVEL, elected by Parliament on January 26, 1993.
  - **Prime Minister**: Vaclav KLAUS.
  - **Main Political Parties**: Civic Democratic Party (CDP); Civic Democratic Alliance; Communist Party of Bohemia and Moravia; Christian Democratic Party; Social Democratic Party; Movement for Self-Managing Democracy-Society for Moravia and Silesia; Christian and Democratic Union-People's Party; Czech Republican Party
- **Slovakia**:
  - **President**: Michal KOVAC, sworn in on March 2, 1993.
  - **Prime Minister**: Vladimir MECIAR.
  - **Main Political Parties**: Movement for a Democratic Slovakia (MDS); Party of the Democratic Left (PLD, the former Communist Party); Christian Democratic Movement (CDM); Hungarian Christian Democrats; Slovak National Party; Social Democratic Party

**March 12, 1994**
- **Main Political Parties**: Party of the Democratic Left; Christian Democratic Movement; Alliance of Democratic Slovakia; Democratic Union; New Democratic Party-New Alternative; Movement for a Democratic Slovakia; Slovak National Party; Hungarian Christian Democrats; Democratic Party

**Dec. 13, 1994**
- **Slovakia**: New coalition government headed by Vladimir MECIAR (Movement for a Democratic Slovakia, Slovak National Party, and Association of Slovak Workers), and dominated by the MDS.
- **Main Political Parties**: Party of the Democratic Left; Christian Democratic Movement; Alliance of Democratic Slovakia; Democratic Union; New Democratic Party-New Alternative; Movement for a Democratic Slovakia; Slovak National Party; Hungarian Christian Democrats; Democratic Party

**Sources**: Economist Intelligence Unit; Oxford Analytica.
### CZECH AND SLOVAK REPUBLICS: Economic Policy Since 1990

**1990**

- **January 1990:** Czechoslovakia applied for membership in IMF and IBRD, and also in OECD
- **Preparation of a new set of laws in February 1990 to provide a legal framework for a market economy:** (i) Law on State Enterprises; (ii) new law providing for unlimited foreign participation; and (iii) law on individual enterprises.
- **Revision of budget for 1990 by Minister of Finance, Václav Klaus involving cuts in state subsidies to reach a budget surplus:** (i) cuts in the armed forces and security by 12.5%; (ii) cuts in the Communist Party, urban transport, housing and domestic heating, and subsidies to enterprises by 10.7%; and (iii) bigger cuts in subsidies to agriculture and some minor extractive industries.
- **Price reform:** price liberalization scheduled for January 1, 1991, simultaneously with introduction of internal currency convertibility for businesses as well as individuals.
- **A strategy of rapid transition through radical economic reform to establish genuine democratization, liberalization of the economy, creation of a market system with free prices, privatization of a substantial part of the economy, and the development of a private sector.**
- **Inflation was to be held in check by restrictive monetary and fiscal policies.**
- **The main opponent to Klaus's strategy was former deputy prime minister, Václav Komárek, who proposed restructuring the economy to improve its competitiveness, and only then to free market forces. The trouble with this view was that the level of competitiveness at that time could only be overcome with international cooperation, which was itself dependent on using market forces to open up the economy.**

**1991**

- **The program of radical economic reform, including the program for price liberalization and "internal" convertibility proposed by the government and Finance Minister Klaus, is accepted by Parliament in September 1990.**
- **Voucher privatization was approved and based on three methods:** (i) some small businesses were to be returned to former owners, while others were to be sold by auction ("small privatization"); (ii) "big privatization" involved putting larger firms onto a commercial basis, converting them to joint-stock companies by January 1, 1991; some of these would be offered partly or wholly to foreign investors; and (iii) the remainder of the shares would be made available to the public in exchange for vouchers distributed to all adults, either free or at a low price.
- **Law on returning nationalized property (restitution) was passed in February 1991: in some cases, property was to be returned, in other cases, financial compensation was to be given.**
- **Law on "big privatization" also passed in February 1991. These enterprises were to formulate their own privatization plans for approval by the relevant ministry. Vouchers were to be "sold" to the public. The law set no minimum to the proportion of shares to be made available in exchange for vouchers.**
- **Comprehensive agreement signed between the government, employers' representatives and trade unions in January 1991 to maintain "social peace". Compromise on the wage indexation system which enabled prices to rise faster for the first few months of the year, but kept the drop in real wages to no more than 12% for the year as a whole. Unemployment benefits were set at 65% of wages earned in the last regular employment. There were also general commitments to retraining, job creation and the protection of trade union rights, irrespective of company ownership.**
- **After the unexpected budget surplus in the first half of 1991, the turnover tax was reduced on certain goods from July 1, and various tax concessions were allowed to encourage investment by enterprises.**
- **The first half of 1991 saw the economy plunge into recession. Industrial output declined by 16.8%, and construction fell 26.3%. The reason was the collapse of demand in both domestic and export markets. The fall in industrial output was accompanied by a dramatic decline in the rate of inflation, but consumer spending collapsed in the same period. The cornerstone of macroeconomic policy throughout 1991 was the determination to control inflationary pressures by maintaining a budget surplus of Kčs 8 bn. High enterprise profits, following price increases early in the year, led to a surplus of Kčs 17.7 bn at the end of June. However, falling consumer demand, leading to lower profitability and lower turnover tax revenues, and a decision to relax the policy in July, turned the surplus into a deficit by the end of November.**
CZECH AND SLOVAK REPUBLICS: Economic Policy Since 1990

1992

- Enterprise debt was cut after pressure from industry and banks: the total level of enterprise debt to banks was about Kc 150 bn, equivalent to a quarter of Net Material Product. The problem was exacerbated by enterprises failing to pay bills to each other, estimated at Kc 80 bn. Funds coming from the proceeds of privatization (about Kc 50 bn) were used to relieve enterprise debt in the form of credit notes to banks, which were used partly to increase their reserves and partly to write off enterprise debts.
- Economic policy in 1990 and 1991 centered on achieving macroeconomic balance and a budget surplus as the basis for the transition to a market economy. Policy in early 1992 was dominated by two considerations: (i) staving off a catastrophic budget deficit; and (ii) to push through "big" privatization, meaning the speedy transfer to private ownership of the majority of state enterprises, even at the risk of fraud and uncertainty over who the new owners were to be.
- The continuing budget deficit led to cuts in state benefits and in subsidies to some sectors. These cuts raised protests, especially in the transport sector where the options by early 1992 were for (i) higher subsidies; (ii) an enormous increase in fares, which were still controlled by the federal government; or (iii) the closure of a large part of public transport. The Czech government came forward with a proposal in February for speedy transport price increases, but it could not be implemented without the approval of the Slovak and federal governments.
- Privatization emerged as the top priority. In the "big privatization" program, 450 investment funds were created to accelerate the process. The rules governing their operation were worked out only in October 1991, and were extremely rudimentary. These Funds needed to provide the Ministries of Privatization in the Czech and Slovak governments with a draft constitution, a draft of the contract that would be offered to investors, and a draft plan indicating any intended sectoral specialization. The "first wave" was intended to ensure the disposal of 2,000 of the Federation's 8,000 state enterprises through voucher privatization.
- After the June elections, a new Czech Minister of Privatization was appointed to review the approval procedure. Under the new rules, direct sales were minimized in favour of competitive bidding or auctions. After approval by the Ministry of Privatization, a project would have to be reviewed by two outside committees, with the power to refer the decision back to the Ministry. Slovakia followed the same policy.
- A "second wave" of voucher privatization was prepared, with separate Czech and Slovak approaches possible.

January 1993

- Split of Czechoslovakia/CSFR into two Republics. Both the Czech and Slovak governments presented separation as the key to more effective economic policies. In the Czech case, it was to make possible more rapid economic reform. In the Slovak case, the hope was that a strategy respecting Slovak "specificity" could bring recovery. In practice, however, Slovak economic policy changed very little during the autumn of 1992. Some previously agreed policies were taken further, leading (for example) to the hasty introduction of VAT at the start of 1993. Others, however, were delayed, most notably in the implementation of the law to make it possible to declare state enterprises bankrupt when they fail to pay their bills.

1993

Economic Policy in the Czech Republic:
- The Czech and Slovak currencies split on February 8, 1993.
- Agreements for methods of payment between enterprises could not be enforced.
- The Czech government withheld distribution of property shares to Slovak citizens to back its demands for compensation for alleged Slovak debts.
- Industrial enterprises faced collapse, but the government was slow in developing a new industrial policy.
- Implementation of the first stage of the policy on bankruptcy.
- The Czech government reintroduced partial wage control on July 1, 1993. The reintroduction followed fears that a rapid rise in wages was likely to prove inflationary. The new wage policy penalized enterprises with more than 25 employees that awarded wage increases of more than 5% above the rate of inflation.
- Law on Bankruptcy effective in April 1993. Included three safety nets.
- Privatization and the Stock Exchange in the Czech Republic: (i) first wave of voucher privatization completed in December 1992; (ii) following passage of a law covering share-dealing in November 1992, a stock exchange opened in Prague in April 1993; and (iii) the immediate effects of privatization on enterprises were largely negative, due to pre-privatization uncertainty, lack of investment undertaken, and lack of long-term plans formulated until ownership issues were settled.
Economic Policy in Slovakia:
- Absence of clear and resolute policy in the face of a rapidly deteriorating economy. The main economic policy was proposed by President KOVAC: falling national reserves and rising budget deficits should be reversed through a massive privatization scheme. This scheme was estimated to generate up to Sk100 bn for the Slovak National Property Fund (SNPF). The SNPF would also take the responsibility for company liabilities: Sk40 bn of privatization revenue would be used to settle inter-company debts, and the remaining Sk60 bn would be used to reduce the budget deficit.
- CSFR separation put pressure on the Slovak crown, but the Slovak government refused to devalue in early 1993. In February, the National Bank of Slovakia adopted temporary measures to protect the decline in the country's hard currency reserves. However, in July, it was announced that a 10.4% devaluation of the Slovak crown against convertible currencies would occur, following an agreement with the IMF.
- To attract foreign investors and improve the image of Slovakia abroad, the Prime Minister, Vladimir MECEIAR, announced tax breaks for foreign investors. Foreign companies registered in Slovakia from January 1, 1993 were granted a tax holiday until the end of the first year of reaching profits.
- New privatization program in Slovakia after the departure of the Minister of Privatization, Lubomir DOLGOS. Prime Minister Meeciar announced in June 1993 his intention to form a special privatization council to speed up the sale of state-owned companies. He also announced an ambitious plan to sell 30%-40% of all state companies by the end of 1993. However, uncertainty about the overall direction of privatization persisted, and the program relied less on the voucher method.
- In August 1993, the European Community raised its quotas for imports from Slovakia and other members of the Visegrad Four. Quotas on industrial products were increased by 10% then, and by another 30% in January 1994.
- End-1993: Minister of Finance Julius TOTH announced his plans to overhaul the Slovak taxation system, which would include the introduction of local taxes for the first time. His statement came after July 9, when the VAT rate was raised from 23% to 25% for most of goods and from 5% to 6% for services.

Economic Policy in the Czech Republic:
- Second wave of privatization: strong public interest and fierce competition between investment funds. The central policy remained the privatization of state property, to be formally completed in 1996.
- Adoption of the 1994 budget by Parliament, with another surplus.
- Revisions in the Banking Law were approved by the Government after the collapse of several smaller banks.
- Adoption by the government of a draft amendment to existing foreign exchange legislation to make the koruna partly convertible later in 1995, in accordance with Article 8 of the IMF Charter.
- Improved economic performance in 1994: (i) GDP growth at 2.5-3.0%, positive for the first time since 1989; (ii) the annual inflation rate was 11%, compared with just over 20% in 1993; (iii) the unemployment remained low, at around 3.5%; and (iv) the government budget was in surplus.

Economic Policy in Slovakia:
- President Kovac modified the church property restitution bill: the law came into effect on January 1, 1994.
- Prime Minister Meeciar is criticized over his influence on privatization. The Democratic Party of the Left (PLD) attacked the amendment to the Privatization Law discussed in Parliament. The draft amendment was designed to widen the scope for government interference in privatization. The PLD suggested that the government should be responsible only for overall policy.
- National Property Fund: two top officials dismissed in late October 1994 to speed up the sale of state-owned enterprises. According to the Ministry of Privatization, during the first wave of privatization, Slovakia sold off over 10,000 firms with a book value of Sk182bn ($6bn). The government privatized 678 large companies with a book value of Sk169bn ($5.7bn).
- End-October 1994: business licensing agreement with the Czech Republic on the temporary licensing of persons and legal entities who had been running businesses on the territory of the partner republic since December 31, 1992. This enabled Slovak entrepreneurs to continue running businesses in the Czech Republic, and vice-versa.
- After the resignation of Vladimir Meeciar, the caretaker Slovak government failed to come up with a coherent economic policy. The main objectives for the following six months were: (i) halting the decline in output (GDP); (ii) slowing inflation to between 10-13%; (iii) containing unemployment from rising above 17%; (iv) achieving a positive balance of payments; and (v) building up Slovakia's foreign currency reserves.
- The decision of Slovakia's central bank to abolish regulatory measures and resume its refinancing of commercial banks was suspended because of a sharp rise in the state deficit at the end of 1993. The central bank provided a direct loan to cover the deficit, causing a potentially inflationary increase in the money supply. The National Bank also tightened its licensing conditions for newly established banks. New banks now had to have minimum founding capital of Sk500mn ($15m), Sk300mn ($9m) more than the previous requirement. Capital also had to be held in cash.
- The MORAVCIK government took measures to reduce the budget deficit: (i) VAT was increased on a number of items and levied on services, at 25% instead of the previous 6%; (ii) duties on alcohol, tobacco and fuel were all raised; and (iii) cuts were made in subsidies on public transport and domestic heating.
### Economic Policy in the Czech Republic:
- Second wave of privatization ended in early 1995. Shares in 861 enterprises were on offer, and 96.3% of shares were allocated to individuals or investment funds. The government planned to have 80% of the economy in private hands by 1996.
- February 1995: the government postponed a tender for a 27% stake in SPT Telecom, but expected to sign a framework agreement on the sale of a 49% stake in two oil refineries. Both deals were needed for foreign capital to finance their modernization.
- Balanced budget is passed for 1995. The Czech Republic remained in a unique position among the former communist countries in maintaining a healthy fiscal position (the 1994 budget showed a surplus of KCs11.4bn).
- Tensions surfaced over exchange rate policy concerning the possible revaluation of the Koruny in early 1995, and preparations for full convertibility. April 1995: adoption by the government of a draft amendment to existing foreign exchange legislation which would make the Koruna partly convertible later in 1995, in accordance with Article 8 of the IMF Charter.
- Social policy emerges as a key priority: in April 1995, leaders of the four parties in the governing coalition agreed on a compromise on the child support allowance issue. However, the government is politically vulnerable on a number of social issues. Opposition parties expected to exploit this weakness in the run-up to the 1996 parliamentary elections.
- May 1995: split of the Christian Democratic Party, one of the parties in the governing coalition, over the party's decision to merge with Prime Minister Klaus's Civic Democratic Party. Relations within and among the coalition parties are growing more conflictual as they jockey for position ahead of the elections in 1996. The conflicting issues concern social policy, the restitution of church property, and the reform of regional administration.
- Trade deficit between January and April, 1995, was Koruny 29.6 bn, compared with a Koruny 14.6bn surplus in the corresponding period of 1994. The gradual real appreciation of the Koruna and rapid real wage growth have partly undermined the competitiveness of Czech firms.
- June 1995: the Czech government decided to cancel the customs union and trade clearing agreement with Slovakia. This agreement was intended to protect the two new states from an anticipated drop in bilateral trade, thereby easing the negative economic effects of the currency split. Under the clearing agreement, goods up to the value of 130 mn Ecu (317mn) per month were paid for in local currencies, while amounts above that limit were paid for in hard currency. The two countries' currencies were allowed to deviate by 5% against the "clearing Ecu". The cancellation of this agreement caused tension between the two countries, and could lead to a decline in Slovak exports and hard currency reserves. However, the abolition of the agreement was an inevitable step in the two countries' transitions to full convertibility.
Economic Policy in Slovakia:

- Soon after his election in December 1994, Prime Minister Meciar declared a moratorium on all direct sale privatizations initiated by the outgoing government. Telecommunications privatization was delayed. Insolvent companies were closed down (145 companies), but closures could be used for privatization.

- January 1995: Parliament approved the new government’s economic program, which advocated Slovakia’s integration with the EU and cooperation with the IMF and other multilateral agencies. Components of the program, which reflected coalition politics more than economic reality, included: (i) fulfillment of the requirements for membership of the EU via the adaptation of EU legal and technical norms, as well as monetary, fiscal and customs policies, trade liberalization, and preparation for a currency union with the EU; (ii) reduction of the fiscal deficit without recourse to tax increases; (iii) use of funds raised by the National Property Fund from privatization for debt service; (iv) continuation of the customs union with the Czech Republic; (v) creation of a banking institution to support small and medium-scale firms; (vi) further privatization through direct sales and the completion of the second wave of coupon privatization; (vii) giving priority to domestic investors in privatization; (viii) support for foreign investment, especially where linked to the introduction of new technology; and (ix) emphasis on infrastructural improvements, including the creation of a Ministry for Construction and Public Works.

- A tough 1995 budget was approved. Health and education expenditures were cut, and the budget allocated to the President’s office was halved. Bonds were issued to cover the old budget deficit (Sk23bn in 1993).

- The European Union agreed to grant Slovakia an aid package worth some Ecu 130mn to help its balance of payments, subject to the country continuing with its reform program.

- April 1995: the Slovak government approved its Memorandum on Economic Policy, which is the basis for promoting IMF trust in the government’s reform program and for creating conditions for medium-term growth. However, the Meciar government decided not to draw on the third installment of its IMF standby loan. Meciar criticized the IMF’s recommendations to reduce subsidies for families, raise the retirement age, and radically increase energy prices for households. Main points of the Memorandum: (i) macroeconomic goals for 1995 include GDP growth of 4%-5%; (ii) inflation of only 8%; (iii) a budget deficit of less than 3% of GDP; (iv) M2 growth of 13.5% in 1995, with a further fall in the discount rate of the National Bank of Slovakia depending on the inflation performance; (v) wage controls to be removed in 1995, based on consultations between the government and trade unions; (vi) speed up privatization through direct sales, sales on the capital market, public auctions, and the second wave of coupon privatization (which was to include property valued at $1 bn koruny, or $1.8 bn); and (vii) legislation to increase the transparency of capital markets and protect the interests of small investors in the second wave of coupon privatization was to be passed before the wave begins.

- May 17, 1995: Prime Minister Meciar called on President Kovac to resign following the passage by Parliament of a government-backed motion of no-confidence in the president.

- July 13, 1995: Parliament approved laws on securities and investment funds and firms and a bill preventing the privatization of strategically important state-owned firms, mainly in the energy and telecommunications sectors. Legal entities trading in securities are required to apply for a license from the Ministry of Finance by October 31, 1995, while investment companies must transform themselves into joint-stock companies by May 31, 1996.

- July 19, 1995: The Slovak Parliament approved the cancellation of the second wave of privatization and the creation of a new bond scheme, as proposed by the Meciar government. The changes, first announced in early June 1995, provide for the replacement of the coupon privatization with a combination of a bond scheme and direct sales by NPF. Under the plan, each of the present 3.5 million coupon holders will be given a bond from the NPF with a nominal value of Sk 10,000 (US$ 343), payable after five years, which can be invested only directly and not through a mediator such as a fund.

- September 21, 1995: The law on investment funds and firms, vetoed by President Kovac in July, was re-approved in early September 1995. The law restricts the rights of the funds, including their right to sit on the boards of the companies they own.

Sources: Economist Intelligence Unit; Oxford Analytica.
<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>November 1988</td>
<td>Prime Minister: Mihos NEMETH</td>
<td>Dominant Political Party: Hungarian Socialist Party (HSP) (formerly the Hungarian Socialist Workers' Party, the ruling party)</td>
</tr>
<tr>
<td></td>
<td>President: Matyas SZUROS (acting)</td>
<td></td>
</tr>
<tr>
<td>October 12, 1989</td>
<td>The ruling &quot;Hungarian Socialist Workers' Party&quot; (HSWP) abandoned its communist ideology and changed its name to the &quot;Hungarian Socialist Party&quot; (HSP).</td>
<td></td>
</tr>
<tr>
<td></td>
<td>New President (elected by Parliament): Arpad GONCZ (interim)</td>
<td></td>
</tr>
<tr>
<td>December 1990</td>
<td>Replacement of the Finance Minister, Ferenc RABAR by Mihaly KUPA</td>
<td></td>
</tr>
<tr>
<td>December 1993</td>
<td>Peter BOROSS replaces J. ANTALL after his death</td>
<td>Coalition Government: HDF/ United Smallholders (UHSCP)/Christian Democrats</td>
</tr>
<tr>
<td>May 1994</td>
<td>Parliamentary Elections</td>
<td></td>
</tr>
<tr>
<td>January 1995</td>
<td>Resignation of Finance Minister, László BEKESI, replaced by Lajos BOKROS</td>
<td></td>
</tr>
</tbody>
</table>

Source: Economist Intelligence Unit.
HUNGARY: Economic Developments Since 1988

1988-1989

- Approval in November 1988 by Parliament of the economic policy entitled "Version A"; Key problems: (i) slow implementation of Bankruptcy Law; (ii) CMEA; (iii) trade restrictions; (iv) continuing misallocation of resources by enterprises; and (v) strong role of the government in the economy.

- New budget for 1989 reduced subsidies: GoH hoped to reduce subsidies by Ft 25 bln (US$ 500 mln), and to continue cutting by the same amount every year until subsidies were no more than Ft 55 bln. Budget deficit for 1989 was set to hit Ft 19.5 bln (US$ 390 mln), or 1.7% of NMP in 1988.

- New Profit Tax Law: rate set at 50%; enterprise welfare contribution raised from 40% to 43% of company's wage bill. Approval by Parliament of a "one-year only" 4% special profit tax to make up extra revenues needed to get through 1989. GoH justified high profit tax by claiming that as owner of state enterprises, it was entitled to a greater share of profits. This policy outraged Hungary's private entrepreneurs, who faced a higher tax burden and continued discrimination in 1989.

- Personal income tax (PIT) bands reduced in number: critics claimed Hungary's PIT provided a strong disincentive to working second and third jobs.

- Banking reform gave commercial banks new authority: from January 1, 1989, commercial banks were able to compete with the National Savings Bank (OTP) for the savings of individuals, while the OTP took on the status of a state commercial bank with authority to grant banking services to companies. But OTP was prohibited from using individuals' savings to finance company loans.

- Wage reform: in 1988, enterprises were punished with a severe progressive tax on wage increases. From January 1, 1989, they were faced with a flat 50% tax on wage increases. However, total wage increases of less than half of VAT growth were exempted.

- Unemployment benefits: available from January 1, 1989. For 1989, a Ft 3-4 bln fund was established to finance unemployment payments.

- In May 1989, GoH made public a draft proposal of economic reform entitled the "Restructuring and Stabilization Program". Main proposals: (i) Hungary must move westwards both politically and economically, establishing closer relations with the EC, EFTA and international financial institutions; (ii) Hungary should rationalize its trade with the CMEA, placing as much of it as possible on a hard currency basis within a 3-5 year period; (iii) ownership relations should move closer to western practice; (iv) economic deregulation should be implemented; and (v) further liberalization was needed in banking and securities, and the budget should be reformed dramatically. Three obstacles to the program: (i) contradiction between the need to reform and Hungary's objective economic circumstances (heavy debt burden made liberalization of imports tricky; the threat of runaway inflation made price reform equally troublesome); (ii) the commitment of GoH and the Hungarian Socialist Workers' Party to compromising on important reform questions; and (iii) lack of social consensus necessary for successful implementation.

- End 1989, an amended version of the "Restructuring and Stabilization Program" was approved for the following 3 years by the EC and the G-24 industrialized nations, which agreed to lend various forms of support to the Hungarians, including substantial credits. The new proposals aimed to overcome Hungary's socialist past and to make the economy viable by: (i) reducing state ownership; (ii) easing restrictions on business start-up; (iii) creating a market economy based on pluralistic ownership; and (iv) comprehensive political changes. Excess protection and lack of competition, the main factors causing an inflation rate of 16%, were to be tackled by liberalizing trade and encouraging the creation of new firms (about 1,700 joint-ventures under the new law on business associations). Concerning foreign trade reforms, strong hard currency export performance was needed: from 1990-1992, exports to the West were expected to grow by 4%-5% annually in volume terms. During this period, a fundamental reform of trade relations with the CMEA would take place, with an increasing amount of trade placed on a hard currency basis.

- May 1989: the IMF withheld the final tranche of a US$330 mln stand-by credit because Hungary failed to meet budget deficit, money supply and current account balance targets. Despite prompt action by GoH to reduce the budget deficit (including a Ft 36 bln reduction of expenditure and a Ft 5 bln rise in revenues via new taxes on the private sector), no agreement could be reached. This prompted a change in ministers to accelerate economic reform.

- Privatization seen as important building block of reform: in July 1989, the Transformation Law set out in detail how a state enterprise or cooperative could turn itself into a private joint-stock holding company or limited liability company.
**HUNGARY: Economic Developments Since 1988**

- The domestic economy in 1989: (i) GDP fell by 1.5%, and private consumption declined by 1%; (ii) industrial output declined by 3.4% in 1989 due to a major decline in orders from the Soviet Union; manufacturing output fell by 3.5%, and output of raw materials and semi-finished goods declined by 3.6%; (iii) inter-enterprise debt rose in 1989 to 200 Bln forint; the enterprise liquidity crisis was exacerbated by the banks' tight credit policy and the onerous system of taxation; (iv) investment declined by 2-3% as GoH cutbacks hit most areas of the economy; total investment reached about 252 Bln Forint in 1989; investments by central and local government as a percent of total investment remained at the same level as in 1988, indicating GoH was taking too strong a lead in making investment decisions; however, GoH and council investments fell more quickly than did investments made by enterprises; (v) consumer price inflation reached 17%; (vi) hard currency trade surplus recorded in 1989 ($587 Mln) helped by hard currency trade with CMEA; this surplus was achieved despite hard currency volume growing by 7.2%, faster than exports (5.0%); Hungary was favored by a 2.6% improvement on its hard currency terms of trade and by an 8.4% improvement in the terms of trade for food products; and (vii) current account deficit increased from $592 Mln in 1988 to $1.4 Bln in 1989, mainly resulting from the fall in net tourism earnings (plus higher interest payments).

<table>
<thead>
<tr>
<th>Early 1990</th>
</tr>
</thead>
<tbody>
<tr>
<td>- A tough austerity budget worked out in cooperation with the IMF. The budget for 1990 was passed by Parliament in December 1989. The new program set a rough guideline for economic performance that GoH tried to meet through indirect means. This budget led to severe consequences on consumers and companies. Estimates were: (i) 20% inflation; (ii) 50 factory closures; (iii) a doubling of the unemployment rate; (iv) increases in council rents by 35% and mortgages by 50%-100%; and (v) a fall in real incomes of 1.0-1.5%. The army budget was cut by 30% in real terms in 1990.</td>
</tr>
<tr>
<td>- Price rises: prices of many agricultural goods were freed, and subsidies were reduced for a wide range of products. GoH made some efforts to compensate the less well off segments of society (raise in family allowances).</td>
</tr>
<tr>
<td>- Economic policy measures in accordance with the IMF: an IMF loan was approved by mid-March, before the elections on March 25, opening the door to EC and bank credits to support Hungary's balance of payments.</td>
</tr>
</tbody>
</table>
### HUNGARY: Economic Developments Since 1988

<table>
<thead>
<tr>
<th>Rest of 1990</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>First non-communist government since 1948 headed by the conservative, right-leaning Democratic Forum (HDF).</strong> The HDF and its coalition partners took office at a time of rapid economic change and serious crisis: the economy was entering a period of transformation, the private sector was growing rapidly, and foreign trade was shifting westward.</td>
<td></td>
</tr>
<tr>
<td><strong>Budgetary policy constrained by IMF (stand-by agreement signed before elections).</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Tight credit policy:</strong> the Hungarian National Bank maintained a tough monetary policy to avoid hyperinflation and instill discipline into the economy (growth in money supply limited to 5%, less than nominal GDP). The World Bank introduced new credit facilities to promote the modernization of the economy, develop internal markets, and support new ventures and exports: (i) creation of a new credit facility at a favorable rate of interest to support the sale of state properties; (ii) preferential fixed interest credits (9%-11%) available to finance convertible currency exports; and (iii) creation of several funds for financing individual and corporate private ventures.</td>
<td></td>
</tr>
<tr>
<td><strong>No &quot;shock therapy,&quot; but a &quot;gradual&quot; approach of systematic change during at least 4 years:</strong> (i) rationalization of government offices; (ii) enforcement of bankruptcy proceedings against loss-making enterprises; (iii) acceleration of privatization in certain sectors; (iv) encouragement of foreign investment; (v) promotion of private ventures; (vi) control of inflation; (vii) review of the state budget; (viii) reorientation of foreign trade towards the West; (ix) increase in private land ownership in agriculture; (x) external convertibility of the forint by end-1991; and (xi) halting of the growth in Hungary's foreign debt. The government program failed, however, to specify how these aims would be achieved. The emphasis on a &quot;social market economy&quot; indicates that, along with structural changes in the economy, the Antall government wished to build up a stable social security network and an efficient health and education system, ensure retraining for the unemployed, a general improvement of the environment, and a market-based housing system. At the same time, Antall promised 3%-4% annual economic growth in the first 2 years of the new system. The apparent lack of strategy to achieve the declared aims indicated the possibility of some &quot;shocks&quot; in the program.</td>
<td></td>
</tr>
<tr>
<td>Privatization was to be speeded up. In September 1990, the State Property Agency (SPA) announced the first phase of a 5-year program to privatize a significant section of the Hungarian economy. The first phase entailed the privatization of 20 state enterprises engaged in a wide range of economic activity. The government hoped to earn US$385-615 mn from the sale of the companies. Approximately 90% of industry was state-owned in 1990, and the government hoped to reduce that figure to under 50% by the end of the first 5 years.</td>
<td></td>
</tr>
<tr>
<td>The domestic economy in 1990: (i) industrial production was down in 1990, and the volume of retail trade fell by over 15%; (ii) inflation rose but wages failed to keep pace; (iii) small businesses thrived; (iv) unemployment grew but remained low; (v) steel industry turned to the West, and restructuring was underway in the coal mining, aluminium industry and coal and gas industry; and (vi) food production dropped by 3%, while the gross value of the crop harvest fell by 8%.</td>
<td></td>
</tr>
</tbody>
</table>
### HUNGARY: Economic Developments Since 1988

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>Privatization moved into second round. SPA issued a preliminary list for the Second Privatization Program (SPP) which included 50 Hungarian companies, all with over half their assets in joint ventures or other subsidiaries. Some progress was made also with the privatization of small businesses. Early January 1991, SPA announced that, in an effort to accelerate privatization, a new program was introduced whereby foreign and domestic investors could make an offer for a state-owned company or for shares of a company.</td>
</tr>
<tr>
<td></td>
<td>Tax incentives for foreign investors were revised. From January 1, 1991, the Foreign Investment Law was amended so that minimum investment to qualify for tax incentives was raised significantly. Before the amendment, a 20% tax credit was available to a joint venture in which a foreign investor had invested Ft 15 mn (US$70,000), or taken a 20% stake of the issued capital. Under new legislation, minimum capital was raised significantly, and periods of eligibility for tax relief were established. Thus, for a joint venture to qualify for a 60% reduction in the 40% profits tax (making it 16%) for the first 5 years and a 40% reduction (making it 24%) in the second 5 years: (i) the joint venture had to have founding capital of more than Ft 50 mn ($700,000); (ii) foreign investors had to own at least 30% of the issued capital; and (iii) more than 50% of the joint venture's annual income had to be derived from manufacturing or from operating a hotel which the company either built or improved through renovation. However, a full tax holiday of 100% for the first 5 years and 60% for the second 5 years was available to companies which invested in priority sectors (electronics, vehicle components, machine tools), and joint venture registration was made easier (they no longer needed permission from Ministry of Finance and Ministry of International Economic Affairs to establish or acquire a majority interest in a Hungarian incorporated company or joint venture).</td>
</tr>
<tr>
<td></td>
<td>New property tax was introduced to encourage individuals living in large houses or flats to move into smaller accommodations (to ease Hungary's housing shortage).</td>
</tr>
<tr>
<td></td>
<td>New economic program presented by new Minister of Finance KUPA. A 4-year economic program put emphasis on privatization, controlling inflation, preparing the groundwork for convertibility, and providing adequate coverage for the old and unemployed. The focus of GoH's program, controlling inflation, was to occur through the reduction of subsidies (from Ft 115 bn in 1990 to Ft 101 bn in 1991) and a tight monetary policy. Customs duties were reduced on industrial equipment and accessories.</td>
</tr>
<tr>
<td></td>
<td>Agriculture: GoH prepared a draft law on agricultural property. Under this law, farmers could regain 80% of lands confiscated and individual compensation would be limited to Ft15 mn. Farmers would not be compensated for livestock and equipment, a factor which would severely hamper the development of private farming given the high rates of interest of 32%.</td>
</tr>
<tr>
<td></td>
<td>New Accounting Law: planned for January 1, 1992 on, this law made it compulsory for companies to have their balance sheets audited and to make them public by May 31 each year.</td>
</tr>
<tr>
<td></td>
<td>New banking bill: the new Central Bank Law put the National Bank of Hungary under the jurisdiction of Parliament. The new banking bill also set bank capital and reserve requirements. The Hungarian Banking Federation became a correspondent member of the Banking Federation of the EC. This gave Hungarian commercial banks access to important information on EC financial matters, and was designed to aid the process of domestic banking reform.</td>
</tr>
<tr>
<td></td>
<td>Ministry of Finance developed a new strategy for privatization: to reduce the powers of the SPA (the main body responsible for this process) because of the failure of the first privatization program, launched in September 1991. A new Privatization Act was to enable the process to accelerate, with SPA concentrating less on acquiring revenue for the state, and paying more attention to the actual capitalization and form of the companies in question.</td>
</tr>
<tr>
<td></td>
<td>The domestic economy in 1991: (i) industrial production down; (ii) demand for energy declined; (iii) agricultural prices suffered from excess output; (iv) unemployment continued to climb, and living standards fell; (v) private savings increased; and (vi) the budget deficit target was exceeded.</td>
</tr>
<tr>
<td>------</td>
<td>-----------------------------------------</td>
</tr>
<tr>
<td></td>
<td>• State budget for 1992 was the major economic policy issue. Rough consensus between GoH and opposition on the priorities of the 1992 budget: (i) GoH anti-inflationary policy should continue; (ii) support for agriculture should be controlled; and (iii) education and social provisions should be gradually strengthened. The 1992 budget deficit was planned to be Ft70 bn, substantially lower than the Ft114.2 bn of 1991. Key feature of the new budget was separating social security and unemployment assistance into earmarked funds within the framework of the budget as a whole. Social Security contributions were revised: social security in 1992 was financed from Ft15 bn in privatization income, state assets valued at Ft15 bn, and Ft20bn directly from the state budget. Social security contribution (or payroll tax) of employers increased from 43% of wages to 44% as of January 1, 1992.</td>
</tr>
</tbody>
</table>
HUNGARY: Economic Developments Since 1988

1993
- Budget deficit (Ft200 bn in 1992) prompted reform of VAT to prevent massive fraud and tax evasion: two VAT rates, 6% or 25% on nearly all goods and services replaced the previous three-tiered regime of 0%, 15% and 25%. In May 1993, the Minister of Finance submitted an emergency austerity budget for 1993 to Parliament. Passed in July, the austerity budget envisaged a deficit of Ft215 bn ($2.3 bn) against the Ft185 bn planned. It authorized the Minister of Finance to issue state bonds to a value of Ft190 bn to finance the Ft215 bn deficit. GoH's first priority was no longer attaining and maintaining equilibrium or controlling inflation, but spurring growth. The slight drop in the overall corporate tax rate, from 40% to 38%, planned for 1994, was part of this new growth-oriented policy.
- GoH opted for a voucher privatization program to speed up privatization and to involve domestic investors more actively in the process. It intended to create more than 500,000 Hungarian share-owners. Investors were able to buy shares in about 70 enterprises. The package involved a loan scheme by which any adult could, on payment of a small fee, acquire up to Ftl00,000 worth of shares via instalment payments. However, sales of state-owned property generated only Ft29.8 bn ($327 mn) in revenues in the first 7 months of 1993, considerably less than planned in the budget. Of this, about 40% came in the form of foreign investment, compared with 60% in 1992 and 80% in 1991.
- A new law broke the state telecommunications monopoly as of January 1993, by regulating the telecommunications market on the basis of concession agreements.
- Ratification of the Association Agreement with the EC and signing of a free trade agreement with the former Czechoslovakia and Poland. According to this agreement, the signatory countries would follow a three-stage reduction of customs duties, starting in March 1993. The agreement would create a free trade zone encompassing 65 million consumers.
- GoH issued new 5-year bonds equivalent to Ft7 bn (about $85 mn), through Kulturvest, a subsidiary of the recently founded Banque Indosuez Hungary. Foreigners were allowed for the first time to purchase these securities directly instead of through intermediaries.
- July 1993: GoH announced a program of so-called "reorganization bonds", introduced to provide potentially viable companies struggling with financial and structural problems with medium-term finance at a lower cost than bank loans. Large companies with assets of more than Ft1 bn (about $11 mn) were selected to participate in the program. They could obtain 3-year financing at an average annual cost of 15%, while GoH guaranteed investors an annual yield of 20%.
- NBH raised a variety of interest rates sharply in the third quarter of 1993, signalling its intention to pursue a tight monetary policy at the expense of economic growth. The credit refinancing rate to financial institutions was raised by 3 percentage points in September 1993 to 22%. Base rates and overnight rates were both up to 22%. Lending and deposit rates increased correspondingly. This policy of high interest rates led to open conflict with GoH.

Early 1994
- No significant changes in the policy of the new Prime Minister, Peter BOROSS. The final 1994 budget included measures to raise extra revenue (including introduction of a turnover tax, equivalent to 0.72% of sales, irrespective of profits and losses). Profit taxes were reduced to 36% from 40%. Most tax breaks on foreign investment were removed, although not retroactively. The top personal income tax rate was increased from 40% to 44%.
- Bank privatization planned by the State Holding Company was to come in three stages. Initially, professional strategic investors would buy holdings of 30%-50%. Then, other long-term financial investors, such as pension funds and insurance companies, would buy another 2%-10%. Finally, the banks would be floated on the Budapest Stock Exchange. Staff and management would be allocated between 5%-10%, and small investors a similar amount. The state planned to retain long-term holdings of up to 25% in the banks. Then GoH proceeded to a two-stage rescue package for 10 commercial banks worth an estimated Ft140 bn ($1.4 bn).
- Further devaluation of the Forint: small devaluation of 1% in January 1994.
HUNGARY: Economic Developments Since 1988

Rest of 1994

- With the nomination of a new Finance Minister in July 1994, Laszlo BEKESI (Hungarian Socialist Party), a new economic program is implemented. "Financial stabilization", both the reduction of the budget and current account deficits and also of inflation, was the key priority. Elements of the policy: (i) to fully meet foreign debt obligations; (ii) cutting the budget deficit as the top priority: defence and public administration budgets would be cut immediately; however, health and education expenditure would be maintained; (iii) further deregulation of the economy; (iv) no increase in the overall tax burden, and abolition of the minimum corporate profits tax (0.72%); (v) maintain the crawling-peg system; (vi) enhance tax breaks for all investors, including foreign investors; (vii) introduce incentives to maintain employment; (viii) encourage private enterprise by increasing the transparency and consistency of legal regulations, tax rules and customs regulations; (ix) reorganize the banking system through the implementation of bank and debtor consolidation schemes and the privatization of commercial banks; and (x) accelerate privatization and improve management of the privatization process, with the merger of the State Property Agency and State Holding Company under Ministry of Finance supervision.
- August 1994: substantial devaluation of 8%, the largest since the 15% devaluation of January 7, 1991.
- October 1994: supplementary budget adopted to keep the 1994 budget deficit within the previous government's original target. Supplementary package designed to raise revenue by Ft24 bn (mainly through increases in import duties and indirect taxes) and to reduce expenditure by Ft27 bn (through halts to public investment projects and savings due to the cancellation of the Expo 1996 World Fair). In October, the IMF warned that the serious current account and budget deficits were unsustainable. The IMF insisted that Hungary slim down its generous system of social welfare provision (in particular, the child support system, pensions, unemployment benefits for school leavers, and health financing).
- November 1994: presentation of an austere budget for 1995, setting the deficit at Ft282.7 bn, or 5.7% of officially projected GDP in 1995. Major tax changes: increase on January 1995 of the preferential rate for VAT from 10% to 12%, and withdrawal of certain goods and services from the preferential rate category to be taxed at the standard VAT rate of 25%. To relieve the tax burden on business, profit tax halved from 36% to 18% on reinvested earnings. GoH also shifted most of the new tax rises onto individual payers: income tax bands were broadened and tax rates on high earners were increased.
- Purge in the public sector contributed to the slowdown in privatization (e.g., sacking the director of the State Asset Management Company, changes of top personnel in public-sector enterprises). However, GoH announced plans for a major acceleration of privatization: to sell 900 companies and to reduce the number of companies under state control over the next 4 years.
HUNGARY: Economic Developments Since 1988

1995

- Horn government presents 3-year medium-term program for 1995-97 which includes: (i) a cost-cutting budget; (ii) tight monetary policy; (iii) a squeeze on consumption; (iv) an increase in prices; and (v) an accelerated program of privatization. Program designed to bring down deficits and stabilize the economy over the following 3 years. The austerity package, proposed by the central bank chief Gyorgy Suranyi and Finance Minister Bokros, is in two parts: (i) immediate devaluation of 9% to boost exports and reduce imports, devaluation of 9% by the National Bank of Hungary in March, and further devaluations of 1.9% in May in June and 1.3% in July; general import duty of 8% in effect since March 20, and to remain in place until mid-1997; companies no longer obliged to exchange their hard currency export revenues for forints, although they will still have to repatriate their revenues to Hungary; and (ii) budget deficit reduction measures and restructuring of the welfare system: wages to be held down in GoH administration and state-owned companies; family benefits no longer automatic, but means-tested; childcare assistance reduced to cover only those entitled to family benefits; from September 1995, a university fee of 2,000 forints is introduced; personnel reductions in the civil service and universities; 9 billion forints set aside to compensate for the welfare payment reductions to be administered by local governments.
- May 1995: austerity package accepted by Parliament. Medium-term success will depend on the implementation of its fiscal component: if spending cuts are not carried out, the ultimate effect of the package could be inflationary.
- Measures taken to tighten monetary policy: NBH increased base interest rate from 25% to 28% in February 1995. Additionally, reserve requirements for commercial banks up to 14% from 12%.
- Bokros’s 25-point program promised ambitious reforms of public spending and a firm lead on privatization matters. Main proposed economic reforms include: (i) restructuring the welfare sector; (ii) modernizing and streamlining state administration as a whole; and (iii) updating the tax system to lighten the burden on entrepreneurs and increase the overall number of taxpayers, reduce the level of social security contributions and clamp down on tax evaders.
- Privatization: (i) the retention of both the AVU and AVRt. The AVU will be slowly wound down, as its last firms are sold off. AVRt will play a key role in coordinating the sale of energy sector companies and, in the future, the direction of state assets in industry; (ii) the sale of remaining small and medium-sized firms held by the AVU to compensate coupon holders; iii) encourage Hungarian pension and insurance companies to enter the stock market to increase the volume of domestic shareholdings and the stability of the market; and (iv) resolution of privatization policy questions by the “economics cabinet”, led by the Finance Minister, with the privatization commissioner resolving technical and day-to-day questions.
- June 30, 1995: Constitutional Court ruled that some elements of Bokros’ austerity package are unconstitutional, bringing fiscal reforms to a halt.
- July 1995: Details of the Privatization Law, passed by the parliament on May 9, 1995, were published in full.
- August 14, 1995: In July, Finance Minister Lajos Bokros unveiled a plan for pensions reform. The plan splits pensions provisions into three parts: the basic pension (30% of total pensions expenditure), employee’s pension (60%), and supplementary pension (10%). The employee’s pension, comprising of compulsory contributions as a proportion of wages, would be shared equally by employees and employers, as opposed to the present system where 24.5% of the contributions are made by the employers and 6% by employees. Incomes above 2.5-3 times the average wage would be exempt from the compulsory contributions and earners of these incomes would have the option of investing in private pension plans.
- September 7, 1995: GoH reversed plans to sell a 35% stake of oil and gas company MOL Rt this year, announcing that it will immediately put a majority stake up for sale to institutional investors.
- October 12, 1995: Macroeconomic data from the second quarter of 1995 showed improvement in internal and external balance. While the balance of payments deficit fell from US$ 1.4 billion (first quarter) to US$ 654 million (second quarter), the budget deficit fell from HUF 144 billion (first quarter) to HUF 76 billion (US$ 550 million, second quarter).
- October 25, 1995: GoH budgetary priorities include a reduction of the government’s social expenditures, reliance on alternative sources of welfare provision such as private pensions and charitable organizations and religious groups, and a reduction of state expenditure to 45-50% of GDP.

Source: Economist Intelligence Unit; Oxford Analytica.
<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 1989</td>
<td>President: JARUZELSKI, elected by Parliament for a six-year term</td>
<td>Prime Minister: Tadeusz MAZOWIECKI, Finance Minister: Leszek BALCEROWICZ</td>
</tr>
<tr>
<td></td>
<td><strong>Coalition Government</strong>: Solidarity/Social Democracy/United Peasants' Party/Democratic Party</td>
<td><strong>Main Political Parties</strong>: Solidarity (Citizens' Committees); United Peasants' Party (PSL); Democratic Party (SD); Social Democracy (SDRP), formerly Polish United Workers' Party</td>
</tr>
<tr>
<td>Summer 1990</td>
<td>Solidarity splits into two major factions: &quot;Center Agreement&quot; (supportive of Lech Walesa) and Democratic Action (supportive of Mazowiecki)</td>
<td></td>
</tr>
<tr>
<td>December 1990</td>
<td>President: Lech WALESZA, elected by universal suffrage (next election due in October 1995)</td>
<td>Prime Minister: Jan Krysztof BIELECKI, Deputy Prime Minister and Minister of Finance: Leszek BALCEROWICZ (&quot;Balcerowicz Plan&quot;)</td>
</tr>
<tr>
<td></td>
<td><strong>Main Political Parties</strong>: Center Agreement (Christian Democratic Party), the most influential in the new government; Citizens' Movement for Democratic Action (ROAD), an opposition umbrella; United Peasants' Party (PSL), the largest of many peasant parties</td>
<td></td>
</tr>
<tr>
<td>October 1991</td>
<td>General elections result in highly fragmented parliament (18 parties). For 2 months, leading parliamentary groups and personalities argued for power and position. Necessity of a coalition government, with Center Alliance most influential.</td>
<td><strong>Main Political Parties</strong>: Center Alliance (Christian Democrat and liberal movement); Democratic Union (social democrats); United Peasants' Party (PSL)</td>
</tr>
<tr>
<td>December 1991</td>
<td>New Prime Minister: Jan OLSZEWSKI, Solidarity lawyer</td>
<td>Conservative government (as a temporary caretaker government)</td>
</tr>
<tr>
<td></td>
<td><strong>Main Political Parties</strong>: Democratic Union (UD); Union of the Democratic Left (former communists); United Peasants' Party (PSL); Centre Alliance</td>
<td></td>
</tr>
<tr>
<td>June 1992</td>
<td>Collapse of Olszewski government due to conflicts with President Walesa</td>
<td></td>
</tr>
<tr>
<td>July 1992</td>
<td>New Prime Minister: Hanna SUCHOCKA, Deputy Prime Ministers: Henryk GORYSZESKI (economic policy); Pawel LACZKOWSKI (political issues)</td>
<td><strong>Coalition Government</strong>: Democratic Union (UD); National Christian Union (ZChN); Congress of Liberal Democrats (KLD); a number of other smaller parties</td>
</tr>
<tr>
<td></td>
<td><strong>Main Political Parties</strong>: Democratic Union (UD); Congress of Liberal Democrats (KLD); National Christian Union (ZChN); Centre Agreement (PC); Union of Democratic Left (SLD); United Peasants' Party (PSL)</td>
<td></td>
</tr>
<tr>
<td>September 19, 1993</td>
<td>Legislative election (Parliament, or the Sejm, and Senate) leads to victory of left-wing parties (Union of Democratic Left and United Peasants' Party). Next election due in September 1997.</td>
<td></td>
</tr>
</tbody>
</table>
### POLAND: Political Changes since 1989

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>October 26, 1993</td>
<td><strong>New Coalition Government</strong>: Union of Democratic Left (SLD); United Peasants' Party (PSL)</td>
</tr>
<tr>
<td></td>
<td>Prime Minister: Waldemar PAWLAK (PSL)</td>
</tr>
<tr>
<td></td>
<td>Deputy Prime Ministers: Marek BOROWSKI (SLD) for economic affairs; Alexander LUCZAK (PSL) for politics; Włodzimierz CIMOSZEWICZ (SLD) for social affairs</td>
</tr>
<tr>
<td></td>
<td><strong>Main Political Parties</strong>: Democratic Union (UD); Congress of Liberal Democrats (KLD); National Christian Union (ZChN); Christian Democratic Movement; Centre Agreement (PC); Union of Democratic Left (SLD); United Peasants' Party (PSL); Labour Union (UP); Non-Party Bloc for Reform (BBWR); Confederation for an Independent Poland (KPN)</td>
</tr>
<tr>
<td>May 1994</td>
<td>Minister for Economic Affairs Borowski (in the wake of the Bank Slaski affair early 1994) replaced by: Grzegorz KOLODKO (SLD), Deputy Prime Minister and Minister of Finance</td>
</tr>
<tr>
<td>March 1995</td>
<td>A new SLD/PSL Government formed after the appointment of Josek OLEKSY (SLD) as new Prime Minister, agreed on February 7 between the leaders of the SLD and PSL.</td>
</tr>
<tr>
<td></td>
<td>Minister of Finance: Grzegorz KOLODKO</td>
</tr>
<tr>
<td>November 1995</td>
<td><strong>November 19, 1995</strong>: Aleksander Kwasniewski defeats Lech Walesa for the presidency.</td>
</tr>
</tbody>
</table>

**Source**: Economist Intelligence Unit; Oxford Analytica.
**POLAND: Economic Policy Since 1989**

| Oct. 1988-July 1989 | • "Consolidation Plan" for period 1986-1990: focused on the need to restructure and stabilize the inflation-wrecked economy  
• Approval by Parliament of 3 key pieces of legislation: (i) "Enterprise Act": equality for all sectors of the economy, whether state, cooperative or private; (ii) new rules for joint-ventures and foreign direct investment; and (iii) substitution of the Planning Commission with a more research-based "Central Planning Office"  
• Banking sector: creation of nine commercial banks on January 1, 1989 from the earlier monobank system. New roles for the National Bank: set the base rate and supervise the other commercial banks. For 1989, the bank rate was set at 44%. This represented a serious attempt to make interest rates an effective policy instrument.  
• To encourage savings, Government established greater incentives for savers to open long-term accounts (66% interest for a three-year account).  
• Defence spending cut by 4% in 1989. Polish defense industries encouraged to switch to production for domestic and export needs. |
| July 1989-early 1990 | • "Balcerowicz Plan" presented to Parliament on December 17, 1989. Program had two crucial objectives: (i) economic stabilization, achieved through policy of demand deflation according to a tight timescale; and (ii) structural reform via privatization and transformation of Poland to a mixed economy. Demand deflation involved a five-point inflation program to (i) balance the government budget; (ii) tighten credit; (iii) make the zloty "internally" convertible; (iv) liberalize prices; and (v) hold down money wage growth. Budgetary policy involved subsidy cuts on coal, energy, transports, fertilisers and some dairy products. The Plan included new spending to support structural change, for retraining, and a welfare safety net to protect the poorest and the unemployed. Prices were liberalized except for 13 groups of goods and services (including some dairy foods, heating, gas, electricity, medicine, transport and alcohol). Higher taxes for firms: the profits tax rate was increased from 30% to 37% in 1990 to offset the phasing out of export and investment tax breaks. Credit conditions for all firms became tougher.  
| Rest of 1990 | • Policy adjustments (during summer 1990): (i) wages allowed to increase by a factor of 0.6 of price increases in August-December period; (ii) annual interest rate fixed from July to end-year at 34%; and (iii) import tariffs applied on 5,000 items, of which 800 were zero-rated in early 1990.  
• The Privatization Program: Krzystof Lis, appointed as Poland's first Minister of Privatization. Privatization legislation accepted by Parliament and Senate in July 1990, involving a two-staged process: (i) State firms transform themselves into joint-stock companies with shares owned by the Treasury; and (ii) no more than 2 years later, the Treasury is obliged to sell its shares by public auction. Foreign participation limited to a maximum 10% of each privatization issue unless special permission obtained (from the head of the "Inward Investment Agency"). Employees of privatized firms allowed to purchase up to 20% of shares at half price. Major obstacle to privatization: shortage of domestic savings. Authorities tried to overcome this problem by offering cheap credits to support private share purchases, and by issuing "privatization bonds" to the population at large.  
• September 1990: creation of Ministry of Privatization to replace the Office for Ownership Transformation.  
• First results of the "Balcerowicz Plan" at end-1990: (i) industrial output contracted by over 20%; (ii) NMP fell by 13% (12% in GDP); (iii) increased unemployment (non-existent in 1989), which grew to over 1Mln at end 1990; (iv) real earnings dropped by 28%; (v) significant hard currency export growth, which increased by 40% in volume and 39.4% in dollar value, resulting in a hard currency trade surplus of US$ 3.8 Bln in 1990; (vi) value added in state and cooperative sectors fell by 21% in 1990, while private sector activity increased by 17% (mainly due to agriculture and private trade); (vii) state sector industrial output fell by 25%, while private production grew by 8.5%, for an overall 23.3% fall in output; and (viii) overall decline in construction activity of 14% in 1990. |
1991 Results: (i) industrial output fell by 11.9% due to domestic recession, the collapse in traditional export markets in Eastern Europe, and strong import competition; (ii) output fell by 22.4% in electrical and mechanical engineering (because of strong orientation to Comecon markets); (iii) expansion of the private sector despite the recession: state industrial output fell by 19.5%, but private sector output increased by 25.4%, with the overall share of private industry growing from 17.4% in 1990 to 24.2% in 1991; (iv) unplanned deficit in state budget of 12.6% of GDP; GoP income forecasts were severely dented by inability of firms to pay corporate taxes or taxes on fixed assets; (v) unemployment was over 2 million (11.4% compared to 6.1% end-1990); (vi) agricultural production held up in 1991, but was affected by deterioration in profitability and squeeze on farm incomes; (vii) real earnings increased very modestly (2%), but the real value of transfer payments increased by 15% (pensions); and (viii) inflation was significantly lower: 1991 average was 70.3%.
Early 1992

- Organisational change in January 1992: Resignation of Balcerowicz as Finance Minister in favor of Jerzy Eysymontt, previously in charge of the Planning Office. Throughout 1990-1991, Ministry of Finance kept tight control over the money supply and fostered a non-interventionist economic policy. By contrast, the Planning Office argued for a more “hands-on” approach with “anti-recession” as its main focus. The Olszewski Government adopted a surprisingly left-leaning, interventionist position on economic issues. Focus now on stimulating economic recovery, although room for maneuver tightly constrained by the need to avoid a damaging return to hyperinflation. The Olszewski Government’s major economic task was to develop a coherent economic policy aimed at lifting the economy out of recession without risking a reignition of hyperinflation.

- Budget: A policy package centered on the State Budget for 1992 had to be found which would be anti-recessionary, satisfy a domestic audience, and also be acceptable to the IMF. This was a dramatic change from earlier policy.

  - February 25, 1992: devaluation of 12% of the Zloty to boost exports.
  - March 1992: a new Budget is proposed by Minister of Finance Olechowski. A budget deficit of Zi 65,500 Bln (around $4.9 Bln) was proposed, about 16% of State spending. Around 34% of revenue was to come from turnover taxes and 40% from profits taxes. The former, a form of indirect taxation, was to increase markedly in 1992 while the rate of profit taxation remained at around 37%. The budget heralded a broad switch from direct to indirect taxation, with an easing of the tax burden on firms (e.g., firms’ “dividends” payment rates were to be halved by mid-1992). It was through measures like this that Olechowski hoped to see an anti-recessionary effect. On the expenditure side, the broad thrust of policy was to cut spending and target it more closely to the most needy.

- Investment and Exports: The fiscal switch aimed to stimulate investment and exports. Measures included: (i) tax breaks for exporters, and the use of the exchange rate to keep exports competitive and exporters’ costs down; (ii) cheaper investment loans for investors and a fall in interest rates in line with inflation of 2% per month, to ensure that credit was available to small enterprises; (iii) industrial restructuring was to be promoted by more vigorous privatization and by breaking up large state enterprises; (iv) costs were to be kept down by limiting the tax burden on firms and by holding wage increases down; Olechowski emphasized that Poland’s international advantage stemmed from being a low-wage economy; and (v) the public welfare sector (health and education) was to become more efficient and partly privatized.

  - May 1992: bill concerning this new budget was rejected by Parliament due to objections that an effective freeze on public sector wages and pensions was illegal.

- New industrial policy: To stimulate exports, i) exporters would benefit from subsidized investment credits, and could qualify for rebates on tariffs paid on imports; ii) support from the government for insurance schemes to help to reduce export risks; and iii) the February devaluation.

- New measures to stimulate investment: (i) tax allowances on investment offered alongside subsidized investment credits; (ii) reduction of the burgeoning tax burden on firms, via profits tax and the tax on assets, the so-called “dividend”; and (iii) more effective use of credit being made available by international agencies and foreign investors.

- Privatization policy: "Continuation" of mass-privatization in the case of small privatization. More effort to attract capital from Polish citizens and from Poles in Western Europe. Privatization process then expected to accelerate, with 50% of state firms turned over to the private sector within the next 3 years. Some sectors expected to stay in state hands in the medium term (fuel and energy, transport and steel).

- Results in the first quarter of 1992: (i) signs of industrial recovery in March 1992, and continued expansion of the private sector; (ii) trade surplus; (iii) no negotiation possible with the IMF concerning the extended borrowing arrangement worth SDR 1,224, which was suspended in September 1991; and (iv) slow rate of inward direct foreign investment to Poland as compared to Hungary and Czechoslovakia (by end 1991, 4,800 joint-ventures set up in Poland representing $700 mln of investment inflow, compared to 9,000 in the much smaller Hungarian economy, representing $2 bln).
## POLAND: Economic Policy Since 1989

<table>
<thead>
<tr>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>New government of pragmatists, composed of (i) the midly left-leaning Democratic Union (UD) led by former Prime Minister Mazowiecki; (ii) the Congress of Liberal Democrats (KLD), led by another former Prime Minister, Bielecki; (iii) the more right-leaning National Christian Union (ZChN); and (iv) other smaller Christian or peasants' parties.</td>
</tr>
<tr>
<td>End-October 1992: Government's program for exports and investment accepted by Parliament, involving: (i) GoP intervention to support recovery, to offer investment incentives where appropriate, to protect industrial sectors ready for privatization and restructuring, and to reactivate agriculture with measured protection and cheaper credits; (ii) stimulation of banking competition to drive down interest rates; and (iii) GoP commitment to bring foreign investment to Poland.</td>
</tr>
<tr>
<td>State Budget: New Minister of Finance, Jerzy Osiatynski (UD), committed to acceptance of the IMF's limit on government borrowing of 5% of GNP, which had been negotiated by his predecessor, Olechowski. This was crucial for Poland's hopes of recovery, since further stages in the Paris Club Program for debt relief depended on an IMF adjustment program being in place. The previous program had been suspended in September 1991 because of Poland's failure to attain key targets. Growing budget deficit for 1992 (expected by GoP to be limited to 7% of GDP at end 1992) due to shortfalls in corporate tax revenues, as well as turnover tax revenues (despite the increase of turnover tax rates from 20% to 22%).</td>
</tr>
<tr>
<td>August 1992: GoP approved draft legislation for the latest version of Mass Privatization, which involved creation of 20 National Investment Funds (NIFs) responsible for holding shares and managing 400-600 leading state firms. The NIFs would be jointly run by a consortium of Western and Polish interests under a majority Polish board with a Polish chairman. Distribution of shares: (i) 33% to &quot;lead&quot; NIF, which would take special responsibility for that enterprise; (ii) 27% to be allocated among remaining NIFs; (iii) 10% for employees; and (iv) 30% for the State Treasury (to be used later as reprivatization bonds, for a fund to pay for public sector wage increases, to support state pensions, or simply to be sold off in due course).</td>
</tr>
<tr>
<td>November 1992: the Słoszocka government delivered the 1993 budget to Parliament for approval. Spending was to grow more slowly than revenue, generating a deficit of Zł 81,000 Bin in line with the IMF threshold of 5% of GDP. This would be consistent with an officially estimated average 1993 inflation rate of 32%, and would accommodate GDP growth of around 2%. Measures proposed to keep spending under control: restrain growth in pensions and public-sector wages. Instead of 100% indexation of pensions and public-sector wages (as required by law), the rate for pensions would be reduced to only 91% of the growth in earnings in the &quot;productive&quot; sector in the previous quarter; that for public sector wages would be 90%, to be reviewed twice in 1993 (April and September).</td>
</tr>
</tbody>
</table>

### Results of the economy in 1992:
- Signs of recovery since April 1992 continued during the first months of 1993. GDP and industrial production increased in 1992. Wood products and transport equipment did especially well, but the coal and steel industries have major problems. Private sector construction was buoyant, while the state sector remained depressed. Agricultural output was badly hit in 1992, but farmers' incomes recovered, as did agricultural terms of trade. The rise in unemployment slowed in late 1992, but accelerated again in January 1993. Inflation continued to decline. Real earnings fell in 1992. Stock exchange activity increased rapidly from a very low base.
POLAND: Economic Policy Since 1989

1993

- Mass privatization delayed in early 1993 by several major amendments made by opposition in Parliament: (i) prohibition on any major tobacco or sugar industry privatization; (ii) ruling in favor of the state monopoly of spirit and tobacco industries; (iii) decision to give workers not only a free 10% stake in privatized companies, but to offer them a further 10% of shares at preferential rates; and (iv) decision to ease interest payable on leases.
- February 1993: After a first rejection, insisting on a full indexation at 100%, the Parliament finally accepted the government's proposed budget in February 1993. This included a freeze on income tax thresholds at 1992 levels to reduce the budget deficit, and to introduce a VAT at 3 rates (22%, 7% and 0%) to replace turnover taxes by July 1993. With new backing from IMF and no barriers to further flows of World Bank aid, Poland looked increasingly attractive to foreign investors.
- The "Enterprise Pact": Wide-ranging social contract to create new opportunities for privatization, wage increases and enterprise development. The Pact represented a new role for workers and trade unions in shaping firm-level developments. Workers' organizations were encouraged to take the initiative in privatization and restructuring. If no plans were produced within three months, the authorities would reserve the right to act centrally.
- Privatization from August 1990 to November 1992: 2,387 state firms privatized. New proposals for privatization were finally accepted by Parliament in April 1993 and approved by President Walesa in May 1993.
- May 1993: Poland's first bank privatization (Wielkopolski Bank Kredytowy).
- Tight monetary and fiscal policies of the Suchocka Government reduced inflation despite the introduction of VAT in July 1993.
- Two broad issues for the SLD (which had the main economic portfolios in hand) to consider: (i) the size of the budget deficit and the need to maintain discipline over spending; and (ii) privatization.
- The economy at end-1993: (i) consumption was the driving force behind GDP growth of 4% in 1993; (ii) private sector grew strongly and made a major contribution to overall economic performance; (iii) unemployment grew by only 1.5% during the year, to stand at 2.9 million (15.7% of labor force) in December; (iv) consumer price inflation was successfully pushed down to 33.3%; (v) healthy recovery in industrial activity: industrial productivity increased by almost 8%; the private sector was the most dynamic part of Polish industry, with sales up by 34.7%, while in sharp contrast, public-sector industry sales fell by 6.5%; (vi) agricultural output rose over the depressed 1992 level (+2.2%); (vii) real incomes fell by 3.2%, with a 5.3% decline in earnings and a slight increase (0.4%) in social transfers; and (viii) state sector employment continued to fall (down by 500,000 in 1993 to 6.1 million), and the private sector level increased by 500,000 to 5.3 million, excluding private agriculture.
### POLAND: Economic Policy Since 1989

#### 1994

- The budget for 1994 sought to stimulate investment and exports while protecting the poorest groups in society. Mr. Borowski proposed an increase in spending in nominal terms of 37.5%, alongside forecasted revenue growth of 35.2%. Consumer prices were expected to increase by 27% in 1994, compared with 35% in 1993. With real spending up by 8.3% and income by 6.5%, the budget was set to play a larger role in the economy than in recent years. The budget was expected to amount to 4.5% of GDP, compared with 3.5% in 1993.
- Increases in budgeted revenues were expected to flow from a broader tax net as well as a greater tax burden falling on individuals and small firms. The Finance Ministry had been keen on capturing the grey economy (which Mr. Borowski believed to account for 20% of GDP) in the tax net.
- Major changes in tax policy included (i) the raising of personal income tax bands to 21%, 33% and 45%, alongside a 40% increase in tax thresholds; (ii) the VAT was being extended downwards to include businesses with annual turnovers of over Zl 2.1Bln ($55,000); and (iii) a new tax was introduced on the very smallest enterprises (turnover below Zl 1.2 Bln a year). Mainstream corporate profits taxes remained unchanged at 40%. The 6% duty levied on all imports also remained in place.
- On the spending side, GoP intended to upgrade benefits payments and ensure that public-sector wages no longer fell behind the "enterprise" sector. The former were expected to increase by 2% in real terms in 1994, and the latter by 1.5%. Investment would qualify for tax relief, particularly export-oriented investment.
- Privatization continued with more attention to "commercialization" and speedier privatization of smaller firms. Seven major state firms were privatized from January to April, two of them by public subscription. A strategic program of "commercialization" was called for by early 1995 for around 1,500 of the remaining 5,300 state enterprises.
- May 1994: interest rate cuts by the National Bank reduced interest charged on refinancing credits from 35% to 33%. The Lombard rate was reduced from 33% to 31%, and the rediscount rate from 29% to 28%. Declining inflation, rising foreign exchange reserves, and improving labour productivity were the main factors permitting the cuts.
- The National Bank announced plans to strike four zeroes off the denomination of the zloty as of January 1,1995. Thus, Zl 10,000 would become one Zloty. This move underlined the fact that Poland had reached monetary stability and that inflation was under control.
- June 1994: Economic strategy for 1994-1997 adopted by Parliament. The central aim of this strategy was non-inflationary growth focused on the development of investment and exports. The program included a commitment to contain the social costs of economic transformation. It also promised that interest rates would remain positive to encourage savings, and that the exchange rate would depreciate in line with inflation. It aimed for single-digit inflation by 1997: CPI was expected to fall from 23.6% in 1994 to 16.1% in 1995, 12% in 1996 and 8.7% in 1997. The strategy anticipated GDP growth of just over 5% per annum for the following 3 years. Consumption was expected to grow more slowly (3.5% p.a.). Other targets: (i) investment growth: 7.7% p.a.; (ii) export growth: 8% p.a.; and (iii) import growth: 5% p.a., in line with GDP. This strategy required external support to maintain fiscal and monetary discipline (e.g., IMF negotiations on a US$900 million standby loan in early 1994). The domestic business community supported the program because of Kolodko's commitment to reduce the formal tax burden by widening the tax net to take in Poland's unregistered businesses and unreported and untaxed activities (accounting for an estimated 20% of GDP).
- August 1994: adoption of a "neo-popiwek" (tax on excess wage growth in state firms) valid until end-1994. GoP hoped that ongoing commercialization of state firms would have gone far enough to provide a permanent check on the growth of state sector wages.
- September 1994: Reduction of crawling-peg depreciation rate from 1.6% to 1.5% per month by the National Bank of Poland to limit money-supply growth resulting from the flow of foreign capital into the country.
- November 1994: after delays in the mass-privatization program, Prime Minister Pawlak finally approved the inclusion of 100 more companies in the program, for a total of 460 companies.
- Labor market: introduction by Finance Ministry of incentives for investment in areas of high unemployment (between 16%-17%) due to increasing enterprise restructuring.
- Results of the economy in 1994: First year of recovery following the launching of reforms in 1990. Growth of 4.5%-5%, as compared with 3.8% in 1993 and 2.6% in 1992. Exports and investment overtook consumption as the major engine of growth (+20% and +8%, respectively).
**POLAND: Economic Policy Since 1989**

| 1995 | 
|---|---|
| **January 1995:** Parliament approves 1995 budget incorporating two measures on taxes and wages: (i) the 1995 budget called for the retention of Personal Income Tax rates of 21%, 33% and 45% introduced in 1994 as a one-year measure; President Walesa argued that these rates should have reverted back to 20%, 30% and 40%; and (ii) further reduction of the crawling-peg depreciation rate, from 1.5% to 1.4%; the crawling-peg was expected to be reduced to 1.1% per month by late 1995. If inflation remained under control, there should be no need for "shock" devaluations. |
| **January 1995:** Introduction of a "new zloty": 1 new zloty = 10,000 old zlotys. The dollar exchange rate at end-January went from approximately 24,000 old zlotys to 2.4 new zlotys. For the following 2 years, both old and new zlotys would circulate in parallel, and prices would be displayed in both forms. |
| **End-February 1995:** creation of some 15 National Investment Funds (NIFs) to oversee the restructuring of 444 state firms under mass privatization. The NIFs are formed from a partnership between Polish and Western banks, management consultants, and Western fund managers. The Anti-monopoly Commission will monitor the process. By mid-1995, it is likely that Polish citizens would be able to buy into the mass-privatization program by purchasing share certificates for around 40 zlotys (US$ 16.6). The EBRD provided US$ 50 million in loans to support enterprise restructuring managed by NIFs, with a ceiling of US$ 3.2 million per fund. |
| **March 1995:** Mr. Pawlak resigns. |
| **July 1995:** New Law on Privatization and Commercialization is passed by Parliament, favoring commercialization with no specified timetable for privatization. Mass privatization of 413 enterprises is launched. |
| **On June 24, 1995:** GoP agreed on a draft budget for 1996. The draft reflects a compromise between the Ministries of Finance and Labor on a key controversial issue, the indexation of pension benefits, as real pensions are allowed to grow in 1996 by 2.5%. The budget is based on the assumptions of a GDP growth of 5.5%, inflation of 17% and a budget deficit of 2.8% GDP for the 1996. While the personal income taxes remain at their 1995 rates of 21%, 33% and 45% and the profits tax stays as 40%, the general import tax is reduced from the current 5% to 3%. |
| **June 25, 1995:** Deputy Finance Minister introduced a proposal for tax relief for holding companies which would allow individual losses within the holding company to be set against profits if 50% of after-tax profits are re-invested. |
| **June 30, 1995:** Sejm approves a new Law on Commercialization and Privatization. |
| **July 21, 1995:** Sejm overturns President Walesa's veto of the Law on Commercialization and Privatization. |
| **July 1995:** 413 firms in the mass privatization program are allocated to the National Investment Funds. The sale of share certificates in the Funds is scheduled to begin on November 29, 1995. |
| **July 31, 1995:** Walesa refers the Law on Commercialization and Privatization to the Constitutional Tribunal, based on an argument that the law violates the separation of powers between executive and legislative branches. |
| **On September 28, 1995:** President Walesa vetoes the government's pension bill, which was to reduce spending on pensions by indexing pensions to prices rather than to wages. |

**Sources:** Economist Intelligence Unit; Oxford Analytica.
MULTI-COUNTRY REFERENCES


"All We Need is Space." 1995. Business Central Europe. (June). 35-36


Claassen, Emil-Maria. "Cleaning the Balance Sheets of Commercial Banks in Eastern Europe and Their Role in Corporate Governance." Weltwirtschaftliches Archiv (Germany) 129 (3): 600-09.


Finance East Europe. 1995. (March 24, May 26 and June 23).


"Keeping the Bulls Running (Hungary)." Euromoney. 170-172.


Main Economic Indicators. 1995. OECD. Washington, D.C. March.


162
Venture Capital & Entrepreneurship in Central & East Europe. 750 Central and East European
for Entrepreneurship Research (EFER) in cooperation with the European Venture Capital

Winiecki, Jan. 1994. "Eastern-Central Europe: a regional survey -- the Czech Republic, Hungary,
Poland and Slovakia in 1993." Europe-Asia Studies. 46 (5). 709-734.

Washington, D.C.


21-38.

CZECHOSLOVAKIA/CZECH AND SLOVAK REPUBLIC REFERENCES

(March).


and Middle East and North Africa Regions Technical Department,
Private Sector and Finance Team, Washington. (July).

Fund. Washington, D.C.

Royal Institute of International Affairs. 46: 1-47.

163


Webster, Leila M., and Dan Swanson. 1993. "The Emergency of Private Sector Manufacturing in
the Former Czech and Slovak Federal Republic. A survey of firms." World Bank Technical 


HUNGARY REFERENCES

Agocs, Peter, and Sandor Agocs. 1994. "The Change Was but an Unfulfilled Promise: 
Agriculture and the Rural Population in Post-Communist Hungary." East European Politics and 

600-09.

Apolte, Thomas. 1991. "Monetary Policy in the Transition to a Market Economy: The Case of 

Financial Times East European Business Law. (September). 94-IV: 3-4


Bunce, Valerie, and Mária Csanádi. 1993. "Uncertainty in the Transition: Post-Communism in 
Hungary." East European Politics and Societies 7 (2) (Spring): 240-75.


Development Institute, National Economic Management Division. Washington. (October).


Oxford Analytica. 1994. (June 22, July 22, 26, August 18, September 2, October 19, 27, December 5, December 15). 1995 (January 4, 24, February 3, 28, March 17, 31 April 28, May 15, 24, June 1, July 10, 14, 18, August 14, 28, September 7, October 12, 25).


POLAND REFERENCES


Creditanstalt Securities a.s. 1995. (October).


<table>
<thead>
<tr>
<th>Country</th>
<th>Distributor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>Selgoa Asia Pacific Pte Ltd.</td>
</tr>
<tr>
<td>Australia</td>
<td>SLOVAK REPUBLIC</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>D. A. Information Services</td>
</tr>
<tr>
<td>Brazil</td>
<td>BHLENBURG</td>
</tr>
<tr>
<td>Canada</td>
<td>CANADA</td>
</tr>
<tr>
<td>China</td>
<td>China Financial &amp; Economic Publishing House</td>
</tr>
<tr>
<td>Colombia</td>
<td>COLOMBIA</td>
</tr>
<tr>
<td>Costa Rica, Belize</td>
<td>CENTRE D'EDITION ET DE DIFFUSION AFRICAINE (CEDA)</td>
</tr>
<tr>
<td>Denmark</td>
<td>DENMARK</td>
</tr>
<tr>
<td>Egypt</td>
<td>EGYPT, ARAB REPUBLIC OF</td>
</tr>
<tr>
<td>Finland</td>
<td>FINLAND</td>
</tr>
<tr>
<td>France</td>
<td>FRANCE</td>
</tr>
<tr>
<td>Germany</td>
<td>GERMANY</td>
</tr>
<tr>
<td>Greece</td>
<td>GREECE</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>HONG KONG</td>
</tr>
<tr>
<td>Hungary</td>
<td>HUNGARY</td>
</tr>
<tr>
<td>India</td>
<td>INDIA</td>
</tr>
<tr>
<td>Indonesia</td>
<td>INDONESIA</td>
</tr>
<tr>
<td>Iran</td>
<td>IRAN</td>
</tr>
<tr>
<td>Ireland</td>
<td>IRELAND</td>
</tr>
<tr>
<td>Israel</td>
<td>ISRAEL</td>
</tr>
<tr>
<td>Philippines</td>
<td>PHILIPPINES</td>
</tr>
<tr>
<td>Portugal</td>
<td>PORTUGAL</td>
</tr>
<tr>
<td>Saudia Arabia</td>
<td>SAUDI ARABIA</td>
</tr>
<tr>
<td>Singapore</td>
<td>SINGAPORE</td>
</tr>
<tr>
<td>South Africa</td>
<td>SOUTH AFRICA</td>
</tr>
<tr>
<td>Spain</td>
<td>SPAIN</td>
</tr>
<tr>
<td>Sweden</td>
<td>SWEDEN</td>
</tr>
<tr>
<td>Trinidad &amp; Tobago</td>
<td>TRINIDAD &amp; TOBAGO</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>ZIMBABWE</td>
</tr>
</tbody>
</table>
Recent World Bank Discussion Papers (continued)

No. 283  Meeting the Challenge of Chinese Enterprise Reform. Harry G. Broadman
No. 284  Desert Locust Management: A Time for Change. Steen R. Joffe
No. 285  Sharing the Wealth: Privatization through Broad-Based Ownership Strategies. Stuart W. Bell
No. 286  Credit Policies and the Industrialization of Korea. Yoon Je Cho and Joon-Kyung Kim
No. 287  East Asia's Environment: Principles and Priorities for Action. Jeffrey S. Hammer and Sudhir Shetty
No. 289  Rethinking Research on Land Degradation in Developing Countries. Yvan Biot, Piero Macleod Blaikie, Cecile Jackson, and Richard Palmer-Jones
No. 290  Decentralizing Infrastructure: Advantages and Limitations. Edited by Antonio Estache
No. 291  Transforming Payment Systems: Meeting the Needs of Emerging Market Economies. Setsuya Sato and David Burra Humphrey
No. 292  Regulated Deregulation of the Financial System in Korea. Ismail Dalla and Deena Kharkhite
No. 293  Design Issues in Rural Finance. Orlando J. Sacay and Bikki K. Randhawa
No. 294  Financing Health Services Through User Fees and Insurance: Case Studies from Sub-Saharan Africa. R. Paul Shaw and Martha Ainsworth
No. 295  The Participation of Nongovernmental Organizations in Poverty Alleviation: The Case Study of the Honduras Social Investment Fund Project. Anna Kathryn Vanderwee Webb, Kye Woo Lee, and Anna Maria Sant'Anna
No. 296  Reforming the Energy Sector in Transition Economies: Selected Experience and Lessons. Dale Gray
No. 297  Assessing Sector Institutions: Lessons of Experience from Zambia's Education Sector. Rogerio F. Pinto and Angelous J. Mtope
No. 298  Uganda's AIDS Crisis: Its Implications for Development. Jill Armstrong
No. 299  Towards a Payments System Law for Developing and Transition Economies. Raj Bhala
No. 300  Africa Can Compete! Export Opportunities and Challenges in Garments and Home Products in the European Market. Tyler Biggs, Margaret Miller, Caroline Otto, and Gerald Tyler
No. 301  Review and Outlook for the World Oil Market. Shane S. Streifel
No. 302  The Broad Sector Approach to Investment Lending: Sector Investment Programs. Peter Harrold and Associates
No. 303  Institutional Adjustment and Adjusting to Institutions. Robert Klitgaard
No. 304  Putting Institutional Economics to Work: From Participation to Governance. Robert Picciotto
No. 305  Pakistan's Public Agricultural Enterprises: Inefficiencies, Market Distortions, and Proposals for Reform. Rashid Faruque, Ridwan Ali, and Yusuf Choudhry
No. 307  The Uruguay Round and the Developing Economies. Edited by Will Martin and L. Alan Winters
No. 308  Bank Governance Contracts: Establishing Goals and Accountability in Bank Restructuring. Richard P. Roulier
No. 309  Public and Private Secondary Education in Developing Countries: A Comparative Study. Emmanuel Jimenez and Marlene E. Lockheed with contributions by Donald Cox, Eduardo Luna, Vicente Paqueo, M. L. de Vera, and Nongnuch Wattanawala
No. 310  Practical Lessons for Africa from East Asia in Industrial and Trade Policies. Peter Harrold, Malathi Jayawickrama, and Deepak Bhattachali
No. 311  The Impact of the Uruguay Round on Africa. Peter Harrold
No. 312  Procurement and Disbursement Manual for Projects with Community Participation. Cita Copal
No. 314  Colombia's Pension Reform: Fiscal and Macroeconomic Effects. Klaus Schmidt-Hebbel
No. 315  Land Quality Indicators. Christian Pieri, Julian Dunman, Ann Hanbgin, and Anthony Young
No. 316  Sustainability of a Government Targeted Credit Program: Evidence from Bangladesh. Shahidur R. Khandker, Zahed Khan, and Baqui Khalily