The Emergence of Private Sector Manufacturing in Hungary

A Survey of Firms

Leila M. Webster
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(List continues on the inside back cover)
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CONTENTS

EXECUTIVE SUMMARY ................................................. 1

INTRODUCTION ......................................................... 11

I. THE PROJECT .......................................................... 13
   Project Objectives ................................................. 13
   The Analytical Framework ....................................... 13
   Research Methodology ............................................ 15

II. BACKGROUND .......................................................... 18
   Economic Reform .................................................. 18
   A Brief History of the Private Sector ....................... 19
   Current Status of the Private Sector ....................... 21

III. THE ENTREPRENEURS ............................................... 24
   General Characteristics ......................................... 24
   Motivation and Personal Qualities .......................... 24
   Entrepreneurship Development ............................... 25

IV. THE FIRMS ............................................................ 27
   General Characteristics ......................................... 27
   Origins of Firms .................................................. 28
   Capital ............................................................. 33
   Labor ............................................................... 35
   Land and Buildings .............................................. 37
   Intermediate Inputs and Raw Materials ..................... 38
   Product Markets and Distribution ........................... 38
   Exports ............................................................ 39
   Trends in Production and Profits ............................ 40
V. THE BUSINESS ENVIRONMENT: CONSTRAINTS AND PROSPECTS 41

Main Constraints 41
The Business Environment: Favorable and Unfavorable Aspects 45
Prospects: Strong Firms Vs. Weak Firms 49

NEEDS FOR ASSISTANCE AND RECOMMENDATIONS FOR ACTION 51

Requests for Assistance 51
Entrepreneurs' Views of Existing Assistance Programs 52
Recommendations for Action 53

VII. CONCLUSIONS 56

What Difference Does History Make? 56
The Impact of Reform Program 57
The Relationship with the State Sector 59
Prospects for the Future 60

ANNEX I TABLES 61
ANNEX II SURVEY QUESTIONNAIRE 71
REFERENCES 99

MAP OF SURVEY LOCATIONS
FOREWORD

When Communist governments fell in Eastern Europe in 1989 and the new governments embraced capitalism, it was immediately clear that the key to renewed growth would be the transfer of capital from the state to private agents and the transfer of economic planning from bureaucracies to individuals. Questions arose quickly about the speed and the means by which private sectors could be built. Privatization of state enterprises was correctly judged to be a complex and lengthy affair, and many observers doubted that the spirit of entrepreneurship needed to spark large-scale private entry could have survived 40 years of suppression. How quickly could individuals who had grown up in socialist economies adopt the values and behaviors of capitalism and amass the capital needed to invest in private businesses? Many asserted that it would take a generation.

This research confirmed that, contrary to expectations, a great spirit of entrepreneurship sprang forth in Eastern Europe within 18 months of liberalization of entry regulations. By September 1991 when this survey work was completed, Hungarian business rosters already contained tens of thousands of newly-registered, private firms, hundreds of thousands of sole proprietorships, and thousands of joint ventures—and the numbers have continued to grow. In addition, this study confirms that many Hungarian entrepreneurs are, in fact, well-qualified to meet the challenges of private enterprise, particularly in terms of general educational levels and technical, production knowhow. The decade of experimentation in Hungary with quasi-private enterprise forms has resulted in a cadre of skilled technicians with experience in some aspects of private business management.

Hungarian entrepreneurs were found to be well-suited to their task, but the business environment of September 1991 was difficult. Recession was deepening and the privatization program for the large State enterprise sector was stalled. Hungary has slid deeper into recession since this survey was carried out, and the privatization program has continued to suffer delays. Therefore, the kinds of constraints on private sector growth documented in this study are likely to be ongoing until these constraints lessen.

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Eva Bakonyi, Director of the B’nai B’rith Foundation in Budapest, served very capably as the local project manager for this research. Research teams were led by Leila Webster, Eva Bakonyi, Wallace Kaufman and Kate Whitmore. Interpreting services were provided by an enthusiastic group of Hungarian graduate students. Logistical coordination was ably handled by Adrienne Mankovits. Sharad Bhandari processed the data, and Amy Chan produced the report. Comments from Mark Schaffer, Anna Selény, David Stark, Ulrich Hewer, Kate Whitmore, Wallace Kaufman and Dan Swanson were particularly helpful for revisions. Howard Pack and David Kemme served as advisors for this project.
ABSTRACT

The central objective of the research that is summarized in this report was to document the characteristics and problems of private sector manufacturers in Hungary about eighteen months into Hungary's latest and most radical reform program. Specifically, this project had three objectives: (i) to develop a profile of entrepreneurs and their firms; (ii) to evaluate firms' prospects, assessing the impact of the reform program on their operations and identifying constraints to growth; and (iii) to formulate recommendations for action, including policy and regulatory changes and initiation of business support programs.

The heart of the research was a firm-level survey of 106 businesses carried out in Hungary in September 1991 by teams of researchers. Firms were randomly drawn from the population of registered, majority privately- and domestically-owned manufacturers with seven or more employees. Excluded were the large self-employed sector, firms engaged in trade or services, and joint ventures. Interviews lasting 3-4 hours were held with each entrepreneur.

Chapter I lays out project objectives, an analytical framework, research issues and the research methodology. Chapter II describes the macroeconomic setting in Hungary in September 1991 and presents an historical and current picture of the Hungarian private sector. Chapters III and IV summarize the characteristics of sample entrepreneurs and their firms. Chapter V analyzes firm-level constraints and presents a profile of successful firms. Chapter VI presents entrepreneurs' requests for assistance and makes a number of recommendations for action, and Chapter VII sums up research findings in the context of research questions raised in Chapter I.

This survey is part of a comparative study of private sector manufacturing in Eastern Europe financed by the Research Committee of the World Bank in December 1990. The project included comparable surveys implemented in Poland in May 1991, and in the former Czech and Slovak Federal Republic in January 1992. An additional survey, financed jointly by the former Industry Development Division of the World Bank and the Chief Economist's Office of the EBRD, was carried out in St. Petersburg, Russia in November 1992. A final project document synthesizing findings from all four surveys will be completed in late 1993 or early 1994.
EXECUTIVE SUMMARY

The Project

The central objective of this research was to document the characteristics and problems of private sector manufacturers in Hungary so that they can be supported as effectively as possible. In doing so, this project also produces an historical record of the status of private sector manufacturing in September 1991, about 18 months into Hungary's latest and most radical reform program. The project had three specific objectives. The first was to develop a profile of entrepreneurs and their firms. The second was to evaluate sample firms' prospects, assessing the impact of recent reforms on firm-level operations and identifying constraints to further growth. Key factors for success were identified by comparing high-performance firms with those that were failing. The third objective was to formulate recommendations for actions to support the Hungarian private manufacturing sector.

The heart of the project was a firm-level survey of 106 firms carried out in Hungary in September 1991. Firms were randomly drawn from the national roster of registered industrial companies, and then narrowed down to a random sample of manufacturing firms that were majority privately- and domestically-owned with seven or more employees. Excluded were the large self-employed sector, firms engaged in trade and services, and joint ventures. Each entrepreneur was interviewed by a research team for 3-4 hours using a standardized questionnaire devised to elicit quantitative and qualitative information.

Background

Following a decade characterized by high foreign debt, slow growth, and rising inflation, the democratically-elected Hungarian government of 1990 launched reforms that were guided by an unambiguous vision of a predominantly private, market economy integrated with Western Europe. Private (including foreign) ownership of productive assets was welcomed, and new laws and regulations were approved to facilitate private sector entry. Macroeconomic measures included: expenditure cuts and tax increases to reduce the budget deficit, tight monetary policy, devaluation of the forint, administrative restrictions on travel abroad by Hungarian tourists, and incentives to encourage re-orientation of exports from East to West. In 1990, real GDP fell by 4.3 percent, unemployment reached 2 percent, domestic demand fell by 5 percent, and the CPI rose by 29 percent. Exports to the West increased, and the convertible currency deficit decreased.

In September 1991, when this survey was conducted, liberalization was well underway, but macroeconomic conditions were increasingly difficult for private manufacturers. Almost 90 percent of consumer and producer prices were freed of government control. Foreign trade had been liberalized, and the forint had partial internal convertibility. Interest rates had been freed for the most part, but competition in the publicly-owned banking sector remained minimal. Most labor restrictions had been abolished, and wages could be freely determined. But on the macroeconomic front, CMEA trade had collapsed; GDP declined by an estimated 9.8 percent in 1991; industrial production fell by more than 20 percent; and private consumption and real fixed investment fell by 8-9 percent and 8-10 percent in 1991 respectively. Moreover, inflation averaged 35 percent for 1991. Privatization of state enterprises stalled.

Despite a difficult economic setting, the private sector boomed when restrictions were lifted. Approved in 1989, The Act on Economic Associations set out the requirements for establishing commercial companies. The response was immediate. The number of commercial companies—mostly limited liability companies presumed to be mostly privately-owned—jumped from about 5,000 in 1989 to
over 40,000 by the end of 1991.1 The number of joint ventures rose from 1,350 at the end of 1989 to over 11,000 by year-end 1991. Non-registered enterprises—mostly sole proprietorships—nearly doubled from 186,000 in 1989 to about 300,000 in 1991. Estimates are that the private sector share of GDP will be about 33 percent in 1992, up from about 25 percent in 1991.

The Entrepreneurs

Characteristics. In broad outline, Hungarian entrepreneurs resembled their counterparts in Poland and the CSFR:2 overwhelmingly middle-aged men with solid technical educations and previous employment in the state sector. Almost 70 percent came from large state enterprises—some in response to the reforms of 1982 and others since 1989. Thirteen percent came from government, and 12 percent came from other private firms. White collar experience, reported by 78 percent of entrepreneurs, was evenly divided between technical and managerial backgrounds.

Many entrepreneurs had substantial experience in private business, some in pre-1989 enterprises and others since 1989. A third of entrepreneurs had owned another private business in the past; a quarter had owned more than one. Ties to the West were substantial, developed through frequent travel in Western countries and through Western investment and trading partners. Many Hungarians were sophisticated in their abilities to analyze foreign markets and negotiate foreign contracts, more so than their counterparts in Poland and CSFR.

Entrepreneurship Development. The Hungarian entrepreneurs interviewed in this survey could not be considered a first wave as many had been operating private and quasi-private enterprises for years, but they did speak clearly of the direction of private sector development in Hungary. They were markedly outward-looking in the sense that many were counting on exports as the major source of their growth. They were fully aware that they could maintain their competitiveness only through the best technology and marketing, and many were anxious to learn Western languages (usually English or German) and gain access to improved technologies.

The dynamics of entrepreneurship in Hungary were complex. In an effort to evaluate linkages between entrepreneurs' backgrounds and the current performance of their firms, entrepreneurs were classified into one of three groups: (i) new entrants with little experience in business; (ii) ex-managers of state enterprises and divisions of government ("nomenklatura"); and (iii) pre-1989 managers of private enterprises including: small craftsmen, quasi-private economic work partnerships operating cooperatively with state enterprises (VGMKs, GMKs), small cooperatives and industrial divisions of agricultural cooperatives. The results showed that each group contained winners: a quarter of each headed the strongest firms in the sample. In terms of relative weight, however, those with pre-1989, private sector experience were the powerhouse of the sample. They accounted for 51 percent of entrepreneurs but over three quarters of total sample sales and exports. Prior experience managing private and semi-private enterprises clearly had enabled these entrepreneurs to build larger and better companies faster.

1/ Enterprise statistics in Hungary are classified by legal form, not by ownership.

2/ Comparable surveys were conducted in Poland in May 1991 and in CSFR in January 1992.
The Firms

General characteristics. As anticipated, almost all firms were limited liability companies. Similar to Poland and CSFR, lack of cash, collateral, and sometimes experience led most entrepreneurs into partnerships. Half were clustered in Budapest and its suburbs, with the rest evenly spread in 42 communities throughout the country. By design, the survey focused on five sectors that accounted for 70 percent of the sample: plastics, clothing, knitting, metal-working, and machine manufacturing. Most firms were small. The average full-time work force was 44 persons. Forty percent of firms had fewer than 20 workers, and 22 percent had more than 50. Average monthly sales were US$109,400.

Origins. Like the Poles and Czechs and Slovaks, Hungary's private entrepreneurs had responded to niches opened by the inability of state enterprises to provide adequate consumer goods and industrial inputs. But unlike in Poland and CSFR, private industrial development began years ago in Hungary. Only 25 percent of sample firms were new start-ups. The remaining 75 percent pre-dated the 1989 reforms, originating as traditional craftsmen, economic work partnerships (GMKs), small cooperatives, industrial divisions of agricultural cooperatives, and state enterprises. Pre-1989 firms contributed a remarkable 89 percent of total sample sales and 87 percent of exports. The principal contributors were former economic work partnerships and small cooperatives.

Capital. Few sample entrepreneurs had entirely new equipment; most was used equipment leased from state enterprises and cooperatives. The average replacement value of equipment in use was US$320,500 per firm, much higher than the average of US$132,321 in Poland and substantially higher than the average of US$244,537 in CSFR. The average value-weighted age of equipment for all firms was eight years.

Hungarian entrepreneurs had received a comparable number of bank loans to their counterparts in Poland and CSFR but over a much longer period. Since start-up (including pre-1989 years), 43 percent of entrepreneurs had received short-term loans, 17 percent long-term loans, and 14 percent had received both. By comparison, 57 percent of Polish entrepreneurs had received working capital loans and 11 percent had long-term credits; 17 percent of Czech and Slovak entrepreneurs had obtained short-term credits and 55 percent had long-term loans. But Hungarians obtained their loans much later in the lives of their firms. Only a quarter of Hungarians had received loans after three years in business; two thirds of Czechs and Slovaks had received loans within their first six months.

Labor. Some notion of a "just wage" prevailed among entrepreneurs who generally paid higher salaries than state enterprises and differentiated between skilled and unskilled workers. The average monthly wage per worker was US$207, with an average total monthly cost per worker of US$303 and average cash and in-kind benefits of US$45. Average benefits accounted for just over 20 percent of wages, compared with a high of 32 percent in Polish firms and a low of 7 percent in Czech and Slovak enterprises. Some highly skilled workers were beginning to see wages rise rapidly.

Facilities. Entrepreneurs had set up production in all kinds of buildings and locations from regular factory buildings in industrial areas to former chicken coops, garages, and single family homes in residential areas. Most entrepreneurs were able to locate and lease factory space without excessive difficulty, but many faced serious obstacles to purchasing their space. At 28 percent, ownership rates among Hungarian entrepreneurs were twice those among Polish entrepreneurs but far short of the 45 percent observed in Czechoslovakia. Many entrepreneurs were blocked from purchasing their buildings by a pervasive scarcity of capital (particularly long-term capital), and the slowness of local and national governments to clear up title problems, value state-owned property, and approve sales.
Product markets. Entrepreneurs purchased 74 percent of their inputs (by value) from state firms and 26 percent from private suppliers. Sixty-nine percent of inputs (by value) were produced domestically and 31 percent were imported. Unlike in Poland where almost all imported inputs were sold by private retailers, state-owned trading companies accounted for a large percentage of imported inputs used by Hungarian entrepreneurs.

Analysis of product markets shows the increasing importance of the private sector in Hungary’s economy. Forty-four percent of entrepreneurs said that they sold mainly to state enterprises, half intermediate goods and half finished goods. Twenty-nine sold mainly to private firms: one-third, intermediate inputs and two-thirds, finished goods. An additional 24 percent sold a mix of intermediate and final goods directly from their shop to both private and state customers. Exporters sold directly to foreign customers and through intermediaries, mostly state trading companies.

Forty-five percent of entrepreneurs were exporting, some in direct sales to foreign buyers and others within subcontracting arrangements. In value-weighted terms, 36 percent of total sample sales was exported, almost all for hard currency. Exporting firms were larger than non-exporters: 37 percent employed over 50 workers as compared to 10 percent of non-exporters. Former small cooperatives were the major contributors to exports.

Trends. The majority of entrepreneurs reported stable or increasing production and rising profits. Specifically, 40 percent of entrepreneurs reported that output had increased in the previous three months; 21 percent said it had remained the same; and 36 percent said it had decreased. When asked whether their businesses were more less profitable than in the first few months following start-up, 61 percent of entrepreneurs reported that they were earning higher profits; 7 percent that profits were unchanged; and 32 percent said that profits had dropped.

The Business Environment: Constraints and Prospects

Constraints. Two issues dominated when entrepreneurs were asked to name the biggest problems affecting their businesses: inadequate finance and soft product demand. Problems with finance were cited first by 54 percent of entrepreneurs. Specific problems included: (i) lack of access to bank credit (cited first by 20%); (ii) falling demand for their products (19%); (iii) delinquent payment by state enterprises for goods delivered (14%); (iv) high interest rates (12%); and (v) difficulty in dealing with banks (8%).

(i) One in five Hungarian entrepreneurs cited lack of access to credit as the single largest problem affecting his/her business. Specifically, sixteen percent said that they had no access to working capital loans and 4 percent complained of no access to investment loans. Researchers observed pervasive ill-will when the subject of bank credit was discussed. Three quarters of respondents said that loans were difficult to obtain and almost all thought credit was unreasonably expensive. Many were of the view that those with strong personal connections and the ability to pay off loan officers had preferential access to loans and more favorable credit terms. As one entrepreneur put it, “Who sits by the fire, gets all the heat.”

Many entrepreneurs were masters at stretching scarce capital. Strategies included: shifting from production to subcontracting; using subcontracted labor for which labor taxes were not levied; recruiting foreign partners who contributed capital; participating in inter-enterprise credit networks; and extensive equipment leasing. But the costs of scarce capital were high. Lining up raw materials and the means for paying for them reportedly took an exorbitant amount of time, and sometimes it proved impossible and in-hand orders could not be filled. Others paid high costs for inputs because they could not finance
bulk purchases. Many were operating with sub-standard equipment because they had no access to investment credits. In some cases, sub-optimal partnerships were formed purely on the basis of capital requirements. Leasing instead of purchasing facilities, use of extensive subcontracting arrangements, and relying on informal loans and credits left some enterprises with books that showed their companies to be far smaller and weaker than they were, a serious liability when approaching a bank for a loan.

(ii) In sharp contrast to Polish entrepreneurs whose demand problems were due mainly to their inability to compete with a flood of imports, problems with soft demand reported by Hungarian entrepreneurs stemmed mainly from diminishing orders from state-owned customers. For example, 35 percent of machine manufacturers cited lack of demand as their top problem, but few reported any significant competition. Rather, they reported that their orders had dropped off when their primary customers, state enterprises, had cut back. Similarly, clothing, knitting and plastics producers faced relatively large numbers of competitors, but they rarely complained of lack of demand for their products. The low level of import penetration and the resulting low level of competition from imports was surprising. Several factors which may have limited the inflow of imports were limitations in access to foreign exchange among individual traders (the force behind Poland’s booming import trade), failure to privatize the retail, small-scale sector which would have been a major broker of imported goods, and the inability of state trading companies to cater to consumer preferences and import goods that would sell.

(iii) Rated as their biggest problem by 14 percent of entrepreneurs, slow payment and non-payment by state-owned enterprises (SOEs) for goods delivered had created serious problems with working capital for many Hungarian entrepreneurs. Virtually all entrepreneurs who relied on SOEs as their major customers were affected negatively by delayed payments. Some had access to suppliers’ credit from SOEs, but most were caught in the bind of paying cash for raw materials and extending 90-120 days credit to state-owned customers. Several had taken delinquent SOEs to court, but the process reportedly was ineffective.

(iv) Twelve percent of entrepreneurs cited excessively high interest rates as their principle problem. Indeed, real interest rates had peaked in August 1991, the month preceding the survey. Considerations of whether real interest rates were unreasonably high include the following. First, banks set rates based on expectations of trends in inflation, and expectations were that inflation would rise. Second, bank officials presumably view lending to small and medium businesses as high-risk ventures. Third, lending to private business is new to Hungarian banks, and it can be expected that banks will move only slowly to admit this new clientele.

(v) A closely related problem was difficulty in working with banks, cited first by 8 percent of respondents. Collateral requirements, reportedly 150-200 percent of loan amounts, were cited as the largest impediment to obtaining loans and the most unfair banking practice. Some entrepreneurs had tried but failed to use in-hand orders as security to supplement collateral—failure that had led to loss of orders in some cases. Most entrepreneurs had hired attorneys to prepare complex loan applications, often paying fees of 3-5 percent of the loan amount. Loan amounts reportedly were limited to three times firms’ start-up capital. Since many entrepreneurs started with the minimum requirement of one million forints, they were limited in loan size to three million forints. The existence of many different credit programs, some with preferential interest rates associated with special incentive programs, may have led to more discord and red-tape than benefits.

Prospects. Researchers classified firms as strong or weak and compared the two groups to identify key variables for success. Firms were classified as strong if production was increasing, profits were rising, and interview team ratings were positive. Weak firms were those for which production was
decreasing, profits were falling, and ratings were poor. The relative strength of sample firms in Hungary is shown by the fact that 27 firms were classified as strong firms, and only 12 were classified as weak. The remaining 67 firms fell in between, ranking positively on some criteria and negatively on others.

Strong and weak firms diverged along many dimensions. Strong firms were larger, and a third of them manufactured machinery. Strong firms were distributed among pre-1989 enterprises and new start-ups in proportion to the sample as a whole, i.e., 75 percent were pre-1989 firms and 25 percent were new start-ups. The weakest new firms tended to be headed by inexperienced entrepreneurs, and some were subcontractors for foreign firms. The weaker pre-1989 firms were those whose production was geared entirely to the state enterprise sector.

Three additional characteristics separated strong firms from weak firms. Both bought most of their inputs from state enterprises, but only 34 percent of strong firms cited state enterprises as their main customers as compared with 73 percent of weak firms. Strong firms thus avoided major problems with declining orders and payments problems. Entrepreneurs in strong firms competed mainly with state enterprises (the least formidable competitors), and only 8 percent listed imports as their major competitors. In contrast, weak firms competed equally with state enterprises, other private firms and imports. As seen in Poland and CSFR, strong firms faced far fewer competitors than weak firms: 72 percent of strong firms reported fewer than 10 competitors compared with only 27 percent of weak firms. It was interesting to note that exporters were equally represented among strong and weak firms. Strong exporters sold directly to foreign buyers, and weak exporters were subcontractors for foreign firms.

Needs for Assistance and Recommendations for Action

Needs. Most Hungarian entrepreneurs requested the same types of assistance as their counterparts in Poland and CSFR: management, marketing, consultation on technology, and language training. "Management" included all areas of operating a business from organizing production to motivating workers to financial planning. Most pre-1989 entrepreneurs were consummate managers with navigation skills perfectly adapted to Hungary’s highly imperfect business environment, but newcomers were floundering without knowledge of basic business practices. The need for marketing knowhow was widespread. Experienced managers knew how to extract the maximum from the system, but the system itself was in flux and most needed to broaden their markets. The imperative of competing in Western markets brought an acute recognition of the importance of upgrading technology, a process considered synonymous with acquiring modern equipment. Exporters, in particular, were anxious to increase profits by upgrading product quality and increasing efficiency. Most Hungarians were not reticent in seeking out foreign trading partners, but they believed that they would be more effective if they could communicate directly in Western languages.

Recommendations. In order of importance, action in five areas is recommended: (i) increase the flow of institutional credit to private sector manufacturers; (ii) expedite privatization; (iii) improve the efficiency and the scope of financial services; (iv) increase the flow of information to private producers, and (v) reduce red tape.

(i) Improving access to credit for private producers would appear to require action on several fronts. First, provision of credit to the private sector must be given high priority within the banking sector. Training loan officers in appraisal and supervision of loans to private companies is critical. Second, loan requirements should be assessed for their reasonableness. Banks should require adequate security from loan recipients, but restricting security only to factory buildings and land seems excessive given the limited opportunities for acquiring industrial property. Third, entrepreneurs in good
standing should have greater access to short-term financing to cover the costs of raw materials. Fourth, banks should incorporate effective means of collecting arrears should they occur. Fifth, preferential credit programs should be eliminated or at least minimized.

(ii) Privatization should be expedited so that assets can flow from state to private hands as quickly as possible. It seems safe to assume that private entrepreneurs would make the most productive use of most assets still under state enterprise control. Privatization would facilitate needed restructuring among those firms that currently depend on the state sector as their primary customers. Further privatization of distribution and retail sectors should improve product markets through new entrants and more competition. Privatization will hasten the demise of large informal inter-enterprise credit networks that benefit insiders but block outsiders.

(iii) Entrepreneurs would benefit greatly from improved efficiency in the banking sector. The process of applying for loans should be simplified and made more transparent. Loan officers' skills in appraising and processing loan applications presumably could be improved. The time needed for routine financial transactions should be greatly reduced, and the procedures for international transfers made more efficient. Banks should assess the feasibility of introducing a wider range of financial services for their clients. Increased competition in the banking sector could produce marked improvements in the quality of financial services in Hungary.

(iv) Institutions that gather and disseminate useful information should be supported. A primary objective of technical assistance for entrepreneurs should be delivery of courses in business basics for new entrants, including how to conduct market research and write business plans. Financial planning should figure prominently in course curricula. Short courses on business basics should be offered as frequently and in as many locations as possible, and minimal fees should be charged.

(v) Regulations should be streamlined and better implemented. Entrepreneurs were forced to wade through excessive red tape, involving large numbers of permits and licenses that could be reduced or at least consolidated. The very process of complying with regulations seemed overly complex, as evidenced by the widespread use of attorneys to complete applications and the pervasive practice of bribing officials to get necessary permits. Specific candidates for improvement are environmental regulations and import procedures. Implementation of existing regulations would be much improved by curtailing the personal discretion of officials, particularly local officials.

Conclusions

The Role of History. A series of questions can be asked about the impact of Hungary's decade of experimentation with partial liberalization of private enterprise on the emerging private productive sector of the early 1990s. The first asks whether the Hungarian private manufacturing sector has grown more rapidly because a large, private second economy was already in place. The answer is yes. Substantial private, informal sectors were already in place when private sector entry was liberalized in Hungary and in Poland in 1989. Accounting for about a third of total employment and of GDP in 1991 in Hungary and about 25 percent of total employment and approximately 20-30 percent of GDP in 1991 in Poland, the private sectors in these countries have expanded their original base to take major roles in their economies quickly. Indeed, 66 of the 106 firms in the Hungarian sample came from transformation of second economy enterprises into first. Such was not the case in CSFR where private enterprise was minimal prior to 1990. Despite rapid growth and dynamic entrepreneurship among the Czechs and Slovaks, the private sector share of employment and GDP had only reached about 16 and 6 percent, respectively, by end-1991. Without question, starting with a substantial base of private activity has meant
that private sectors can more quickly assume a larger portion of total activity than when the starting point is a small base.

A second question is whether performance and prospects differed for pre-1989 firms and new start-ups? Survey results indicated substantial differences. Without question, privatized pre-1989 enterprises (including craftsmen, state firms, enterprise work partnerships, small cooperatives, and industrial divisions of agricultural cooperatives) were the powerhouse of the sample. To recap, pre-1989 companies accounted for 75 percent of sample firms, 89 percent of total sample sales, and 87 percent of exports. The 27 new firms in the sample accounted for only 11 percent of sales and 13 percent of exports.

Prospects for each group were less clear. Many of the pre-1989 firms faced substantial needs for restructuring. Their former customers, state enterprises, were declining and demand for their products typically was declining. Many were trying to shift product lines, upgrade product quality, and increase efficiency. Important advantages held by these firms included the considerable skills of most of their managers, sweet deals on buildings and equipment, and membership in the large network of personal connections among suppliers and customers that prevailed in Hungary. New start-ups (by experienced and inexperienced entrepreneurs) held the considerable advantage of having chosen their products, their mix of capital and labor, and their technologies after price liberalization when price signals were relatively undistorted. Therefore, they were spared restructuring costs and their resources could be used to purchase facilities and new equipment. Their disadvantages generally included a lack of experience and the fact that many were building businesses from scratch.

The final question ask whether entrepreneurs who managed private or quasi-private businesses before 1989 had better chances for success in the present? Survey results indicated that experience made a big difference. To recap, entrepreneurs who managed private or quasi-private businesses before 1989 represented 51 percent of entrepreneurs surveyed but nearly 80 percent of total sample sales and exports. In short, Hungary's experiments in the 1980s with improving the performance of the state sector through allowing quasi-private enterprises to serve as back-up producers may have failed in their stated goals, but the dividends have been great as realized in a cadre of strong industrial producers who now operate as the backbone of the new, private industrial sector.

The Impact of the Reform Program. Without question, the manufacturing firms surveyed in this project had benefitted enormously from the reforms of 1989 and 1990. The large private sector contribution to GDP is powerful testament to the success of the reforms and the extent of the response.

Survey results indicated that three policy areas warrant examination: privatization, foreign exchange policies, and financial sector reform. Despite a spate of approaches, few large state industrial enterprises had been privatized in Hungary, and privatization of the small-scale sector—including the retail sector—was far from complete in September 1991. Postponement of privatization of those firms whose assets will be transferred had postponed adjustment among many of the private producers who relied on state customers. Their chances for survival would be heightened by speedy privatization so that they can evaluate the new signals and re-orient their businesses as needed. As documented in this report, product markets in Hungary were weaker than anticipated. Incomplete privatization of the small-scale sector—particularly the retail sector—was a major cause of this weakness. The contrast to Poland where near-complete small privatization contributed to the formation of a vibrant, competitive retail sector was obvious. Of note is the fact that difficulties in accessing production equipment and physical space owned by the state—a big problem in Poland—were mitigated for many Hungarians through leasing arrangements.
Lack of access to foreign exchange for individual traders at levels needed to import goods for resale on a reasonable scale had limited the inflow of imports and also contributed to weak development of retail markets. The impact of this policy was mixed, and the implications unclear. On the one hand, limiting the inflow of imports through limiting the range of agents who could bring them in meant that competition, especially from imports, was moderate at the time of the survey. Protection from imports afforded entrepreneurs time to build their businesses before they were subjected to full competition on world markets. But on the other hand, limiting participation of individual traders relegated most foreign trade to large, mostly state-owned trading companies interested in high-volume sales to state firms with reportedly little feel for the needs of small producers.

The banking sector was not meeting the needs of the majority of Hungarian entrepreneurs. Researchers observed many firms that appeared fully capable of expansion but were stymied for lack of credit. The existence of numerous special programs with varying interest rates had created tremendous ill-will among the majority who had not benefitted from lower rates. Also, financial services appeared especially poor with very slow transaction time and unnecessarily cumbersome procedures for foreign transactions. Entrepreneurs spoke eagerly about the possibility of transferring their business to foreign banks but apparently, none were available for routine services.

The Relationship with the State Sector. The private sector in Hungary appeared to be surprisingly well-integrated with the state sector, a state of affairs that bodes well for an integrated, mixed ownership economy in the future. This high level of integration is attributable to a number of factors. First, many entrepreneurs had personal relationships with managers in state firms, and their spirit was not one of competitiveness but one that sought mutual advantage. Second, some state enterprise managers allowed entrepreneurs to participate in inter-enterprise credit networks that, in effect, extended suppliers' credits. The majority of entrepreneurs leased their equipment and buildings from state firms. In these ways, an inter-dependence was created. Third, researchers heard no reports of prejudice against private entrepreneurs or of refusals to sell to them as was the case in the former CSFR. Managers in state firms were well-accustomed to working with private entrepreneurs when they were operating economic work partnerships inside of state firms, and their experience likely reduced their prejudice. At the same time, it must be noted that the high level of cooperation between private entrepreneurs and state enterprise managers served to maintain a dense network of personal connections among industrialists, a network that had created barriers for some newcomers who were without these connections. A key element of the transformation underway in Hungary will be substitution of formal markets for informal ones.

The Future. Prospects for the continued strong development of private sector manufacturing in Hungary appeared mixed at the time of the survey. Many entrepreneurs were prospering, especially those who had established export markets. The exceptions were those who were tightly linked to the state sector which was declining rapidly in September 1991, and those who were entirely new to private business. Privatization would clarify the parameters of the new economy for those who are clinging to sales to the state sector and force them to restructure their businesses along new, competitive lines. New, inexperienced entrants will continue to struggle as they learn to operate their businesses effectively, and technical assistance that provides basic business skills would help them. Over time, increasing imports will increase competition as will the growing numbers of new entrants. Those who produce simple consumer goods where economies of scale pertain may be the most vulnerable to increased competition, but those who rely on export markets should continue to prosper. Loosening of credit for private producers would greatly facilitate private sector growth.
INTRODUCTION

This report contains the findings of a survey of private manufacturing firms carried out in Hungary in September 1991. This survey is part of a comparative study of private sector manufacturing in Eastern Europe financed in December 1990 by the Research Committee of The World Bank. The project includes comparable surveys implemented in Poland (May 1991) and in the former CSFR (January 1992).

The report is organized as follows. Chapter I lays out project objectives, an analytical framework, research issues, and the research methodology. Chapter II describes the Hungarian economy at the time of the survey, and presents historical and recent trends in private sector development. Chapters III and IV lay out basic characteristics of sample entrepreneurs and their firms. Chapter V analyzes firm-level constraints and presents a profile of successful firms. Chapter VI summarizes entrepreneurs' requests for assistance and offers recommendations for action. Chapter VII sums up survey findings in a series of conclusions.

The nature of this research should be kept in mind. Survey findings are based on in-depth, three- to four-hour interviews with a carefully selected group of private Hungarian manufacturers in September 1991. The results are, in effect, a series of detailed quantitative and qualitative photographs of firms operating in the economic and social setting of that time. To the extent that the circumstances of September 1991 are ongoing in Hungary, findings in this report remain relevant. To the extent that circumstances have changed, some findings presented here become part of an historical record documenting the situation of private manufacturers some 18 months into the most recent round of major reforms in Hungary.
1. THE PROJECT

Project Objectives

The central objective of this research was to document the characteristics and problems of private sector manufacturers in Hungary so that they can be supported as effectively as possible. In doing so, this project also produces an historical record of the status of private sector manufacturing in September 1991, about 18 months into Hungary's most recent reform program.

The research had three specific objectives. The first was to develop a profile of entrepreneurs and their firms. The second was to evaluate firms' prospects, assessing the impact of recent reforms on firm-level operations and identifying constraints to further growth. Factors associated with success were obtained by comparing high-performance firms with those that were failing. The third objective was to formulate recommendations for actions to support the Hungarian private manufacturing sector.

The Analytical Framework

The theoretical literature provides no single framework to analyze the development of private, productive enterprises in formerly centrally-planned economies. The most closely related area of research is empirical work on firm-level response to structural adjustment programs. The sources of economic problems in pre-1989 Hungary and the magnitude of the transformation involved differ from those in typical adjusting countries, but the many of the macroeconomic imbalances and the measures taken to stabilize and liberalize the economy are similar. Without underestimating the unique set of circumstances in Hungary, the empirical evidence on firm-level response to adjustment programs is used here as a starting point from which to formulate research issues.

Firm-level Response to Adjustment: What We Know

At the aggregate level, the Report on Adjustment Lending II confirms that private investment response in many adjusting countries has been disappointing, and offers some possible explanations, as follows:

(i) Tight monetary and credit policies discourage investment by raising the cost of credit and the opportunity cost of retained earnings.
(ii) Real devaluation discourages investment by raising the price of imported capital goods and intermediate inputs as well as reducing aggregate demand.
(iii) With trade liberalization comes a reduction of investment in import-substituting industries.
(iv) Potential investors are unwilling to risk their capital when they are uncertain about the continuity of new policies, regulations, prices and incentive schemes.
(v) Cuts in government investment in complementary public projects, such as roads, ports and telecommunications, have a negative impact on private investment.

Dornbusch offers a further discussion of the lack of investment response in adjusting countries in "From Stabilization to Growth." He views stabilization and adjustment as necessary but insufficient conditions for resumption of growth, and criticizes official institutions for offering "unjustifiably rosy scenarios...based on assumptions that do not hold in practice." His explanations for low levels of private investment include: (i) budget corrections that reduce real wages and hence internal demand, without which firms will not invest; (ii) diversion of scarce available resources away from exports and import substitution; (iii) short-run contractionary effects of real depreciation on demand; (iv) cutting back of credit and an inability to finance government support measures; and (v) entrepreneurs' lack of confidence in the stability of the policy environment.

Firm-level studies include those carried out in Africa—Ghana, Malawi, Senegal and Tanzania—and in Latin America—Chile, Argentina and Uruguay. Researchers in Africa found no shortage of entrepreneurs but rather a host of constraints to growth, mostly traceable back to the macroeconomic setting. Sample entrepreneurs were squeezed by higher input costs and an inability to raise prices due to eroded domestic demand and competing low-cost imports. Even the strongest firms lacked access to institutional credit for working capital and investment, despite an apparent willingness to pay going interest rates. Entrepreneurs were isolated from larger, growing markets and information sources, and they had few linkages with large enterprises. Regulatory environments were neutral in principle, but in practice government officials had failed to facilitate private sector growth by processing required paperwork in a timely fashion, cutting through bureaucracy, and supplying needed information.

An analysis of the prospects for Ghanaian firms in 1989 revealed that the process of adjustment envisioned by policy-makers for the state enterprise sector was in full swing in the private sector. Firms that could not compete in the post-reform environment were failing, and those that had located niche markets were expanding. Weaker firms manufactured mass-produced, undifferentiated goods—typically textiles, clothing, and simple metal products—that competed, or rather failed to compete, with imports. Stronger firms exploited niche markets, producing custom goods that faced little competition from imports. Where they did compete with imports, successful producers aimed for the top end of the market. Successful Ghanaian entrepreneurs were young and well-educated, often with engineering backgrounds.

Researchers in Latin America looked at how managers of firms were adapting to import competition. They found that four strategies for improving efficiency dominated. First, firms met import competition by greater product specialization and improvements in product quality. Second, they


consolidated production and reduced their labor force. Third, they increased investment in new
machinery and plant modification. And fourth, they purchased foreign blueprints and negotiated profit-
sharing and licensing agreements with foreign firms.

In addition, researchers in Latin America found that appreciated exchange rates resulted in
"misplaced" investment to produce exports that never materialized. A shift from production to importing
was common in all three countries when the trade regimes were liberalized. Of particular relevance to
Eastern Europe was the finding that policy reversals delayed adjustments in efficiency. Adjustments were
most comprehensive and quickly implemented when there was little doubt about the irreversibility of
policies.

Research Issues

Combining the above empirical work on firms in adjusting economies with knowledge of
conditions in Hungary, the following appear to be the key questions for research:

(i) How have the components and sequencing of the 1989 Hungarian reform program
affected the prospects of private producers? Which elements of the program have been
most beneficial to private manufacturers' growth and which have been most detrimental?

(ii) What are the major constraints reported by entrepreneurs? What are the sources of these
problems, and how do they differ from firm-level constraints reported in other adjusting
countries?

(iii) What factors enable some entrepreneurs to overcome constraints and operate profitably?
What measures will entrepreneurs take to maintain profitability in their changing,
increasingly competitive environment? Are their strategies to maintain competitiveness
similar to those found in Argentina, Chile and Uruguay?

(iv) What is the impact of the dominant state sector on private producers? How has the
government's privatization program affected the formation and development of private
sector manufacturing?

(v) What kinds of assistance could most effectively support the development of Hungarian
private manufacturing?

Research Methodology

The Approach

Changes were underway in data collection practices of the Central Statistical Office in Hungary,
particularly concerning private sector statistics. However sound, aggregate data reveal little about
entrepreneurs' perceptions and behavior, and almost nothing about their prospects. In-depth interviews
with owners and managers provided researchers with detailed information about firm-level responses to
macro-level changes.

Selection of a nationally representative sample was fundamental to formulating valid conclusions
about the Hungarian manufacturing sector as a whole. A nation-wide approach also produced key data
about the distribution of opportunities across regions, and between rural and urban areas.
The Population

To be eligible for inclusion in the population from which the sample was drawn, firms had to be:

(i) registered companies;
(ii) at least 51 percent privately- and 51 percent domestically-owned;
(iii) engaged primarily in manufacturing;
(iv) employers of seven or more workers.

The population was restricted to registered firms--limited liability and joint-stock companies--because incorporated enterprises tend to be larger and more formally organized than other types of private domestic units. Fairly complete rosters of registered firms exist in all three sample countries, a key factor in obtaining comparable cross-country samples. Under the assumption that larger firms have stronger prospects than smaller ones, an employment criteria was applied to exclude microenterprises.

Several large and important groups of private enterprises were excluded from this population. First, self-employed persons (sole proprietorships) who number some 300,000 in Hungary were excluded. Anecdotal evidence was that some large enterprises operated as sole proprietorships but the vast majority appeared to be quite small, averaging two workers including the owner. Inclusion of this group would have precluded selection of a representative sample as the population of self-employed persons was unknown. Rapid turnover would have limited the possibility of tracking firms over time. Second, joint ventures and foreign firms were excluded because their constraints and prospects are likely to differ substantially from those of domestic firms. Third, firms whose primary activities are trade and services were excluded because these entrepreneurs operate their businesses under a different set of parameters than those affecting manufacturers.

Sample Selection

The sample was randomly selected in May 1991 from the roster of about 6,000 registered manufacturing firms in the Central Statistical Office in Budapest. With the longer term objective of cross-country comparisons, a random sample from the whole population was supplemented with five stratified random samples representing pre-selected industrial activities common to all three sample countries. The activities are plastics, clothing, knitting, metal working and machine manufacturing.

The sample was selected in two segments. An initial sample of 1,800 firms drawn from the national roster was reduced through a subsequent step in which letters were sent to the entrepreneurs selected asking them to verify their activities, ownership structure, and number of workers, and inviting them to join the survey. Based on the pre-set criteria, the final sample of 106 firms was selected randomly from about 1,200 respondents, and it represents about 1.7 percent of the population of all registered manufacturers. Firms were located throughout the country, and two-person survey teams

7/ A potential source of bias arises from non-respondents to the letter. To the extent that letters were not returned because businesses had failed, survey results are overly positive. To the extent that entrepreneurs did not respond because they were indifferent to a World Bank survey or were doing well and had few complaints, survey results are overly negative.

8/ Official statistics in Hungary categorize registered companies by legal form but not by ownership. The population of purely private manufacturers, therefore, is unknown.
spent about three hours with each entrepreneur (see survey questionnaire in Annex II and map of firm locations in Annex III). The survey was completed in three weeks, finishing at the end of September 1991.
II. BACKGROUND

The objective of this chapter is to summarize the larger context within which survey findings should be understood. Section A begins the chapter by outlining the recent history of economic reform in Hungary and the macroeconomic setting prevailing at the time of the survey. Section B summarizes the history of private sector development in Hungary. Section C describes aggregate trends in the private sector since 1989.

Economic Reform

The Hungarian government’s commitment to maintaining a high standard of living among its citizens has been reflected in its strategies of attracting foreign capital (via borrowing and direct investment) from the West and its experiments with increasing production through partial reform of central planning. Hungary began its move toward a market economy as long ago as 1968 with the adoption of the New Economic Mechanism which provided for partial use of financial and economic levers to regulate the economy. Under the NEM, the system of directives and commands from the center and central allocation of inputs were eliminated. Prices were to be flexible and linked to exchange rates. Profitability and consumer preferences were to be taken seriously.

The oil shock of the early 1970s worsened the terms of trade. Despite efforts to compensate, including devaluation and export promotion, imports outpaced exports for the next 10 years. Borrowing from the West began in earnest in 1978. This early experiment with partial reliance on market mechanisms was de-railed, however, when the differential between profitable and unprofitable enterprises grew and opposition to the reforms stiffened. Central control was once again strengthened even as the macro-economic situation declined.

Between 1980 and 1988, the economy grew at only 1-2 percent a year. Full employment was maintained, but inflation averaged over 7 percent per year. Gross domestic investment stagnated. Maintaining international liquidity became the first priority as credit became more difficult and expensive to obtain. The foreign exchange surpluses needed to service the debt turned to substantial deficits in 1986 and 1987. By 1988, debt had increased to 80 percent of GDP, and the debt-service ratio as a percentage of exports in convertible currency had increased to 50 percent. By the end of 1989, Hungary faced its most severe foreign exchange liquidity crisis since 1982. Inflation was near 20 percent, and real wages were declining.

The democratically-elected Hungarian government of 1990 launched reforms that were guided by a clear and unambiguous vision of a predominantly private, market economy integrated with Western Europe. Private (including foreign) ownership of productive assets was welcomed, and new laws and regulations were approved to facilitate private sector entry. Measures taken included: expenditure cuts and tax increases to reduce the budget deficit, tight monetary policy, devaluation of the forint, administrative restrictions on travel abroad by Hungarian tourists, and incentives to encourage re-orientation of exports from east to west. In 1990, real GDP fell by 4.3 percent, unemployment reached 2 percent, domestic demand fell by 5 percent, and the CPI rose by 29 percent. Exports to the West increased, and the convertible currency deficit decreased.

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2/ Data in this section came from national authorities and World Bank reports. See Annex Tables 1.1 and 1.2 for further details.
In September 1991, when this survey was implemented, liberalization was well underway. Almost 90 percent of consumer and producer prices were free of government control. Foreign trade was liberalized, and the forint had partial internal convertibility. Interest rates were more or less free, but competition in the state-owned banking sector was minimal. A fledgling stock exchange and a securities market were initiated. Most labor restrictions were abolished, and wages could be freely determined.

Economic recession deepened in 1991. CMEA trade virtually collapsed; GDP declined by an estimated 9.8 percent in 1991; and private consumption and real fixed investment fell by 8-9 percent and 8-10 percent in 1991, respectively. Industrial production fell by more than 20 percent in 1991, especially in manufacturing industries: 34 percent in the machine industry; 24 percent in light manufacturing; 31 percent in metallurgy; and 32 percent in construction. Unemployment reached 8 percent. Moreover, inflation averaged 35 percent in 1991. Privatization of state enterprises stalled as spontaneous privatization, widespread in 1989 and the first half of 1990, was curtailed and authority over privatization was centralized in the newly formed State Property Agency.

A Brief History of the Private Sector

After almost 20 years of suppression, private enterprise began to re-emerge in 1968 with the "New Economic Mechanism" (NEM). The 1968 reforms largely failed in their stated goal of stimulating improvements in efficiency and profitability in the state enterprise sector, but several measures incorporated in the reforms proved critical in setting the stage for the more thoroughgoing emergence of private enterprise in 1982. First, the rural private economy was boosted when individuals who farmed household agricultural plots were encouraged to sell their produce directly to consumers and through agricultural cooperatives. By 1972, about half of all Hungarians were engaged, at least part-time, in private farming with private plots contributing about a third of total agricultural production. Second, state employees and pensioners were allowed to work legally in small private enterprises on a part-time basis. Third, the liberal attitude that prevailed in the late 1960s until the crackdown in 1972 permitted a surge of illegal and quasi-legal private activities which functioned as an extensive, informal private sector which survived into the late 1980s when private enterprise was fully liberalized.

The reforms of 1982, initiated in the context of severe economic imbalances in the late 1970s and early 1980s, marked the turning point for private sector development in Hungary. The government legalized new quasi-private enterprise forms, similar to household agricultural plots but designed for industrial production. These new enterprises were couched in terms of work partnerships which would be the "household plots of industry". The government's objectives in these reforms were to: mobilize

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12/ As Seleny points out, "From 1982 on, authorities could no longer refuse a license or otherwise prohibit any citizen choosing to work on his or her account, or to found or participate in the new partnerships, as long as certain basic legal and professional precondition were met."
private investment, reduce shortages of consumer goods, and maintain the standard of living among key workers in the state sector at a juncture when real wages had stagnated. Among the numerous private and quasi-private enterprise forms legalized in 1982, four were critical precursors of Hungary's private industrial sector today (see Origins, Chapter IV):

(i) Enterprise work partnerships, VGMKs, were formed by groups of no more than 30 skilled workers who served as subcontractors to their state employers, bargaining for service and production fees, operating after hours using enterprise equipment (for a fee) and collecting additional wages from the firm's cost accounts (thereby operating outside of wage ceilings). VGMKs ensured the loyalty of skilled workers, eased shortages, and raised the efficiency of the host state firm. In 1982, 29,000 workers worked in VGMKs, rising to 268,000 in 1986.

(ii) Business work partnerships, GMKs, were also limited to 30 members who were required to participate directly in the work and to contribute to the initial capital. GMKs also sold their products and services to the host enterprises but also to other enterprises. Laky reported that 2,336 GMKs with 11,914 members were organized in 1982 increasing to 10,889 with 72,199 members by 1988. Tax rates were low, but limitations on the number of participants led many GMKs eventually to convert to small cooperatives.

(iii) Small cooperatives which operated on an almost fully private basis (as opposed to large cooperatives which operated much like state firms) could be formed either by a maximum of 100 individuals who split off from non-agricultural large cooperatives or by a minimum of 15 people who were required to invest start-up capital of one month's salary each. Initial capital was indivisible, but there was no maximum on the number of employees. According to Laky, 145 small cooperatives operated in 1982, increasing to 2,847 by 1988 with 83 percent employing fewer than 100 persons.

(iv) In 1982, restrictions on industrial production in agricultural cooperatives were lifted, and these industrial units proliferated. They met the needs of the agricultural cooperatives for manufactured goods, but they also were allowed to sell their products on the open market.

To sum up, there is no fixed date when the private sector re-emerged in Hungary. The informal private economy grew rapidly during the 1970s, particularly in agriculture and services. The reforms of 1982 enabled hundreds of thousands of industrial workers to participate in various forms of private and quasi-private industrial enterprises. As emphasized throughout this report, the capital assets and professional experience consolidated in enterprises initiated in 1982 form the foundation of the private industrial sector today.

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13/ Nee and Stark, p. 142.

Current Status of the Private Sector

Enacted January 1, 1989, the Act on Economic Associations set out the requirements for establishing and operating commercial companies in Hungary.\(^{15}\) This company law, in combination with the Law on Transformation of May 1989, covers both the establishment of new domestic and foreign companies and the transformation or corporatization of previous enterprise forms, including state-owned enterprises and the 1982 enterprise forms.\(^{16}\)

The Associations Act specifies that limited liability companies, surveyed in this project and known in Hungary as KFTs, may be established by one or more persons. Minimum start-up capital is one million forints or approximately US$13,500, in cash or in kind. Registration procedures include drafting articles of association which must be signed by all founding members and an attorney and notarized. Application is then made to the Court of Registration to register the company. The company assumes legal personality when it is registered in the Trade Register, and it may then use start-up capital placed on deposit and initiate its activities.

The Structure of the Hungarian Enterprise Sector

The structure of the enterprise sector in Hungary is more complex than that of other Eastern European countries, partly a result of the many hybrid enterprise forms of the past decade and partly a result of the official classification system. Enterprises are classified in one of three categories:

(i) The socialized sector is comprised mainly of state-owned enterprises and cooperatives of two types: large cooperatives which operate much like state enterprises, and small cooperatives which function like private entities except for the indivisibility of their capital.

(ii) Registered or legal entities--authorized by the Association Act of 1989--include limited liability and joint-stock companies. This category includes domestic and foreign firms and joint ventures. All indications are that most joint-stock companies have majority state ownership, and that most limited liability companies (domestic and joint ventures) are majority privately-owned.\(^{17}\)

(iii) Non-legal entities includes sole proprietorships (self-employed persons) and the 1982 enterprise forms including enterprise work partnerships (VGMKs), business work partnerships (GMKs), and other partnerships (PTTs and BTs).

\(^{15/}\) For details of the laws applicable to private enterprise, see "Legal Reform for Hungary's Private Sector" by Cheryl Grey, Rebecca Hanson and Michael Heller. The World Bank, CECTM, Working Paper # 983, October 1992.

\(^{16/}\) Foreign investment is regulated by Hungary's foreign investment law, Act XXIV approved in 1988. This law has proved conducive to foreign investment with its provisions for 100% ownership of companies by foreigners, profits repatriation and tax incentives.

\(^{17/}\) Of note is the fact that national statistics on registered companies differentiate firms only by legal status with no indication of ownership. Therefore, it is possible to ascertain the number of registered companies but not the number that are privately-owned.
Numbers of Units and Sectoral Distribution

Growth in the Hungarian economy clearly has been led by domestic commercial companies and joint ventures, both registered in steadily increasing numbers since 1989 (Table 2.1). The number of commercial companies—mostly limited liability companies presumed to be mostly privately-owned—jumped from about 5,000 in 1989 to over 40,000 by the end of 1991. The number of joint ventures rose from 1,350 at the end of 1989 to over 11,000 by year-end 1991. Non-registered enterprises—mostly sole proprietorships—nearly doubled from 186,000 in 1989 to about 300,000 in 1991. The numbers of units in the socialized sector have remained relatively constant since 1989, an aggregate figure that masks considerable internal splintering within state enterprises. The cooperative sector remained stable at about 7,000 units, about 4,000 mostly state-controlled large cooperatives and 3,000 mostly privately-operated small cooperatives.

Table 2.1. Total Economic Units g/  
(Number of Units)

|                       | 1989 | 1990 | 1991 | Rate of Growth  
|------------------------|------|------|------|------------------  
|                        |      |      |      | 90/89(%) | 91/90(%)  
| State Enterprises      | 2,288| 2,801| 2,652| 22.4      | -5.3       
| Cooperatives           | 7,546| 7,212| 7,232| -4.4      | 0.3        
| Large cooperatives b/  | 4,313| 4,057| 4,131| -6.0      | 1.8        
| Small cooperatives g/  | 3,233| 3,155| 3,101| -2.4      | -1.7       
| Commercial Companies d/| 5,091| 18,336| 42,211| 260      | 130        
| Joint ventures         | 1,349| 5,693| 11,335| 322      | 99         
| Non-legal Entities e/  | 186,291| 233,984| 300,000| 26      | 28        

a/ Source: Central Statistical Office officials and bulletins.
b/ Operating essentially as state enterprises.
c/ Operating almost entirely as private enterprises.
d/ Includes joint-stock and limited liability companies, mixed state and private ownership.
e/ Includes sole proprietorships (self-employed persons), and quasi-private partnerships such as VGMKs, GMKs, BTs and PTTs.

A sectoral breakdown shows that trading firms make up a significant share of all commercial firms, rising to 39 percent in 1991 from 28 percent in 1989 (Annex Table 1.3). Although growth in industry has been strong with an increase from about 2,000 units at end-1989 to 9,500 at end-1991, the share of firms in industry fell from 38 to 22 percent over the period. A breakdown of the 9,500 industrial limited liability and joint-stock companies in 1991 shows that they are clustered in four activities: electro-mechanical (49%); machinery (22%); light manufacturing (18%); and food processing (10%) (Annex Table 1.4). The highest growth rates since 1989 have taken place in food processing and light industry, with significant growth in construction materials and precision instruments.

The largest increase among sole proprietors since 1989 has occurred in industry, though an enterprise size averaging only two people in 1991 shows that most are one and two-person endeavors (Annex Table 1.5). Sole proprietors engaged in trade are noteworthy for their divergence from the pattern seen in Poland. The numbers of self-employed persons engaged in trading activities in Hungary
increased only by 70 percent between 1989 and 1991 (from 44,000 units to 75,000 units) compared with a growth rate for the same period of 750 percent among Polish self-employed traders (72,000 units in 1989 to 550,000 in 1991). The slow growth of individual traders in Hungary is a direct reflection of Hungary's policy of limiting access to foreign exchange for self-employed persons and of the slowness with which the small retail sector has been privatized.14

The explosive growth in foreign investment in Hungary has been well-documented (Annex Tables 1.6-1.9). In 1991, over 5,000 new joint ventures were registered, injecting nearly three-quarters of a billion US dollars (55 billion forints) into the Hungarian economy. Major investors (in value terms) were Austrians (24%), Americans (23%) and Germans (14%). Over half of joint ventures registered by mid-1991 had 50 percent or less foreign share, but the number of 100 percent foreign-owned firms has grown rapidly—from 244 enterprises at the end of 1990 to 759 by mid-1991. Primary sectors by value of capital among joint ventures include: electro-mechanical products (46%), services (19%) and food processing (32%).

GDP, Employment and Trade

The government estimates that the share of GDP contributed by the private sector in 1992 will be about 33 percent, up from about 25 percent in 1991.18 The private sector share of employment is unclear but estimated at about a third of the total labor force. Employment figures for registered industrial companies show that over two-thirds have fewer than 20 employees, and 85 percent have fewer than 50 workers.19 However, the prevalence of labor subcontracting observed in firms interviewed in this survey suggests that many registered companies may be substantially larger than indicated by official figures. In 1990, the last year of extensive ruble trade, commercial companies accounted for 28 percent and 22 percent of ruble and non-ruble trade, respectively.

Privatization

Privatization of state enterprises had largely stalled in September 1991. Public outcry against spontaneous privatization (common in 1989 and 1990), where managers in state enterprises moved assets out of state firms and into their own private companies, resulted in centralization of the privatization process in mid-1990 in a newly-established State Property Agency (SPA) charged with regulating the transfer of assets from state to private hands. Since then, results have been poor in spite of initiation of a variety of routes by which state firms could be privatized. The industrial sector remained largely in state hands at the time of the survey, though it was clear that much internal splintering was underway. State property could be sold to private individuals, but approval by the SPA reportedly was arduous and slow. Of importance in the context of this survey was the fact that only a small percentage of the retail sector had been privatized.

18/ Of the 10,000 retail outlets singled out in 1990 for auctioning to private builders, only 680 had been sold as of mid-1992; leases were auctioned for 1,980 units; and 560 stores were included in other sales. See "Privatization in Hungary" by Susan Glanz. November 1992.


20/ Official employment statistics at the enterprise level are presented in ranges, i.e., <20, 21-50, 51-300, and >300.
III. THE ENTREPRENEURS

In broad outline, Hungarian sample entrepreneurs resembled their counterparts in Poland and
CSFR: overwhelmingly middle-aged men with solid technical educations and previous employment as
managers in large state firms. In closer detail, a distinctly Hungarian shading emerged. Section A
of this chapter summarizes entrepreneurs’ main characteristics— their ages, education and work
experiences. Section B discusses their motivations for entering private business and the personal qualities
they applied to their work. Section C speculates about the course of entrepreneurship development in
the Hungarian context.

General Characteristics

The youngest entrepreneur interviewed was 24 years old, and the oldest was 65. The average
age was 43, the same age as the average Czech and Slovak sample entrepreneur and one year older than
the average Polish entrepreneur. Ninety-four were men and 12 were women. Half had university
educations, and just under 20 percent had post-graduate degrees. As expected, few (15%) had any
training abroad.

Typical of the new manufacturers in Eastern Europe, almost 70 percent of Hungarian sample
entrepreneurs came to the private sector from employment in large state enterprises—some with the
reforms in 1982 and others since 1989. Thirteen percent came from government, and 12 percent came
from other private firms. White collar experience, reported by 78 percent of entrepreneurs, was evenly
divided between technical and managerial backgrounds. Fewer than a third came from blue collar
backgrounds.

Almost half were manufacturing products that were significantly or entirely different than those
produced in their previous jobs but even when faced with entirely new issues of production, most
Hungarian entrepreneurs had a self-confidence and flexibility that conveyed an unusual sense of optimism.
Such was the case of the young engineer who paid too much for an Italian machine to make long-sleeved
plastic gloves for use in artificially inseminating cows. When his middle man became overstocked, this
producer sold a million short-sleeved gloves to the USSR. At the time of the survey, he was pitching
his wares to foreign service stations and felt sure of success.

Motivations and Personal Qualities

Hungarians listed independence first among their primary personal objectives in entering private
business (33% of respondents), followed closely by achievement (28%) and financial remuneration (18%).
Cited by 38 percent of entrepreneurs, frustration with work in state firms was the most common factor
precipitating entry into the private sector (apart from liberalization of the regulations governing entry).
Typical was a talented and well-paid engineer from a state transport company who could not get the
Ministry of Transport to allow his state firm to produce his design for a more efficient trolley bus. This
entrepreneur found foreign backing and formed a limited company to produce his buses because, "We
needed some success, to have a product of our own." The second and third most frequent precipitating
factors, reported by 14 entrepreneurs each, were loss of employment and perception of a profitable
opportunity.

21/ Comparable surveys were conducted in Poland and CSFR by The Industry Development Division
of The World Bank, and cross-country comparisons are brought into the text where relevant.
The survey's rough attempt to compare entrepreneurs' personal characteristics with classic personality traits of entrepreneurs gave some credence to the stereotype of the passionate, independent Hungarian. Compared with Polish and Czech and Slovak entrepreneurs, Hungarians were more likely to describe themselves as high achievers, restless and easily bored with routine, risk-takers willing to live with uncertainty; and as independents and loners. Similarly, they were less likely than the Poles, Czechs and Slovaks to describe themselves as practical, disciplined and concerned with control. In addition to their classic personality traits, researchers were impressed by Hungarian entrepreneurs' avid desire for new information to apply to their businesses, voiced without concern as to whether the source was domestic or foreign.

Table 3.2: Personal Qualities of Sample Entrepreneurs

<table>
<thead>
<tr>
<th>Personal Qualities</th>
<th>No. of Responses</th>
<th>Percentage of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>High achiever, easily bored with routine</td>
<td>52</td>
<td>19</td>
</tr>
<tr>
<td>Risk taker, willing to live with uncertainty</td>
<td>45</td>
<td>16</td>
</tr>
<tr>
<td>Like to feel in control of what is going on</td>
<td>40</td>
<td>14</td>
</tr>
<tr>
<td>A practical person with practical skills</td>
<td>36</td>
<td>13</td>
</tr>
<tr>
<td>Highly disciplined, committed to hard work</td>
<td>33</td>
<td>12</td>
</tr>
<tr>
<td>Self-confident, fairly sure of success</td>
<td>29</td>
<td>10</td>
</tr>
<tr>
<td>Independent, loner, somewhat separate from others</td>
<td>32</td>
<td>11</td>
</tr>
<tr>
<td>Grew up in difficult troubled family</td>
<td>10</td>
<td>4</td>
</tr>
<tr>
<td>Other</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>281</td>
<td>100</td>
</tr>
</tbody>
</table>

*Entrepreneurs were shown this list of personal qualities and asked to choose the three that described them best.*

Entrepreneurship Development

The Hungarian entrepreneurs interviewed in this survey could not be considered a first wave as many had been operating private and quasi-private enterprises for years, but they did speak clearly about the future of private sector development in Hungary. A third of entrepreneurs had owned another private business in the past; a quarter had owned more than one. Ties to the West were substantial, developed through frequent travel in Western countries and through Western investment and trading partners. Entrepreneurs were markedly outward-looking: most looked to the West for technologies and corporate models, and many were counting on exports as the major source of their growth. They were fully aware that they could maintain their competitiveness only through the best technology and marketing, and many were anxious to learn Western languages (usually English or German) and gain access to improved technologies. Some were sophisticated in their abilities to analyze foreign markets and negotiate foreign contracts, more so than their counterparts in Poland and CSFR. For example, one Budapest clothing manufacturer monitors the Dusseldorf and Berlin fashion shows, and his wife travels twice a month to Vienna scouting for fashions. He says they can introduce a new style into Hungary two weeks after it debuts in Western cities.

The dynamics of entrepreneurship in Hungary are more complex than elsewhere in Eastern Europe because entrepreneurs and enterprises have entered the Hungarian private sector from a broader range of sources than normally is the case in post-socialist economies. Looking at entrepreneurs' backgrounds (see Chapter IV for origins of firms), it was clear that they fell naturally into three groups:
(i) new entrants with non-managerial backgrounds and little experience in private business; (ii) ex-managers of state enterprises and divisions of government ("nomenklatura"); and (iii) pre-1989 entrepreneurs including small craftsmen, industrial workers from quasi-private enterprises operating in association with state enterprises (VGMKs, GMKs), and small cooperatives and industrial divisions of agricultural cooperatives.  

Researchers were interested in knowing which of these three groups would be the most successful in the new economy. To answer this question, entrepreneurs were classified as members of one of the above three groups based on careful examination of each of their backgrounds. The first group was labeled "outsiders", the second "insiders", and the third "pre-1989 entrepreneurs". Using this paradigm, 30 percent of sample entrepreneurs were outsiders; just under 20 percent were insiders; and 51 percent were pre-1989 entrepreneurs.

Researchers analyzed the differences in the characteristics and performance of firms owned by each group of entrepreneurs. In terms of the numbers of successful firms, each had equal representation among the strongest firms in the sample. A quarter of each group headed "strong" firms (see Chapter V for strong firm, weak firm analysis). In terms of relative weight, however, pre-1989 entrepreneurs clearly were the powerhouse of the sample. They accounted for 51 percent of sample entrepreneurs but over three quarters of total sample sales and exports. Insiders accounted for 14 percent of sales and 12 percent of exports, and outsiders only 9 percent of both sales and exports. Experience clearly mattered.

In addition to their experience, chances for success among pre-1989 entrepreneurs were also increased by their membership in a strong and prevalent informal system of personal contacts which reportedly influenced the terms of access to factory space, production equipment, raw materials, credit and markets for final products. Experienced entrepreneurs had the advantages of having established suppliers and customers, some access to inter-enterprise credit, and preferential access to factory space. The development of this system can be traced generally to the communist regime which maximized the utility of personal contacts and more specifically, to a history of private enterprise that survived by relying on informal networks to evade restrictions and access needed production inputs.

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22/ Entrepreneurs' histories, in some cases, were distinct from the history of their firms. Experienced entrepreneurs (labelled pre-1989 entrepreneurs) were found in privatized firms and in new start-ups (see Chapter IV, Origins).
IV. THE FIRMS

Section A of this chapter summarizes sample firms' characteristics: ownership structure, age, location, sectoral distribution and size. Section B outlines firms' origins, a key to understanding Hungarian private manufacturing in September 1991. Section C discusses entrepreneurs' use of physical capital and finance. Section D describes the labor force: its size, gender breakdown, compensation, skills and training, and representation. Section E focuses on the use of land and buildings; Section F on raw materials and intermediate inputs; Section G on product markets and distribution; Section H on exports; and Section I on trends in production and profits.

General Characteristics

As anticipated, almost all firms were limited liability companies. Similar to Poland and CSFR, lack of cash, collateral, and sometimes experience led most entrepreneurs into partnerships. Partnerships (72% of firms) typically were composed of friends and former colleagues. Family groups were next at 20 percent. Only 9 percent of entrepreneurs started alone.

Sixty percent of firms were located in cities, 25 percent in towns and 15 percent in villages. Reflecting population distribution in Hungary, half were clustered in Budapest and its suburbs with the rest evenly spread in 42 communities throughout the country. Typically, firms in Budapest produced for national and export markets, and companies in towns and villages had captured local, niche markets. Such was the case for one small printing firm that was the first in the Balaton region.

By design, the survey focused on five sectors that accounted for 70 percent of the sample (Table 4.1). Firms in non-targeted sectors were engaged in a variety of traditional industries as well as some specialty products, many in pollution control devices. One small firm made blood sugar monitors and soil nitrate meters, and another was perfecting a process to treat leather wastes.

<table>
<thead>
<tr>
<th>Table 4.1 Distribution of Sample Firms by Sector (Number of firms)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Number of Firms b/</td>
</tr>
</tbody>
</table>

g/ Other sectors include printing, musical instruments, furniture, food processing, construction materials, transport, electronics, shoes, and chemicals.

b/ The sectoral distribution shown here is not strictly representative of the whole private manufacturing sector because the sample selection targeted firms in the five sectors listed above. The sample is roughly representative, however, because four of these five sectors were major ones in the population at the time of the survey.

Firms were small. The average full-time work force was 44 persons. Forty percent had fewer than 20 workers, and 22 percent had more than 50 (Table 4.2). Average monthly sales were

23/ The original target was 15-20 firms in each targeted sector but knitting firms were underrepresented as it became clear in the field that most private knitters preferred to remain in sole proprietorships and few had incorporated.
US$109,400. The smallest firm had monthly sales of US$4,500 and the largest had almost US$3 million. Despite their small size, sample firms in Hungary were larger than firms in Poland where the average full-time labor force was 32 workers and average monthly sales were US$47,100, and in CSFR where firms averaged 42 workers and average monthly sales were US$56,000. The larger size of the Hungarian firms presumably reflects the fact that three-quarters had operated for at least three years.

### Table 4.2 Distribution of Sample Firms by Size

<table>
<thead>
<tr>
<th>Number of Workers a/</th>
<th>Number of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-10</td>
<td>10</td>
</tr>
<tr>
<td>11-20</td>
<td>32</td>
</tr>
<tr>
<td>21-50</td>
<td>38</td>
</tr>
<tr>
<td>&gt; 50</td>
<td>23</td>
</tr>
</tbody>
</table>

a/ One full-time worker equals one full-time employee or eight hours of work by one or more part-time employees.

b/ The size distribution does not represent the entire private sector because firms with fewer than 7 workers were excluded from the sample.

There was considerable variation in firm size across the targeted sectors. Clothing and knitting firms were the smallest with average monthly sales of US$32,285 and US$61,694 respectively, and machinery manufacturers were the largest with average sales of US$221,795. The smallest firms with 1-10 workers had average sales of US$25,613, and the largest with 50 or more workers averaged US$332,556 in sales. It was interesting to note that the smallest firms were located in towns, and the largest were in cities and in rural areas where they emerged from village-based cooperatives.

**Origins Of Firms**

Like the Poles and Czechs and Slovaks, Hungary's private entrepreneurs had responded to large and obvious niches opened by the inability of the state enterprise sector to provide adequate consumer goods and industrial inputs. But unlike in Poland and CSFR, private sector development in industry began years ago in Hungary. In that light, it was not surprising to researchers that only a quarter of sample firms were new start-ups, and three-quarters were transformed into private, registered companies from various pre-1989 enterprise forms including: traditional "craftsmen", state firms, small cooperatives, industrial divisions of agricultural cooperatives, economic work partnerships and various types of associations and partnerships. It is important to note that many quasi-private, pre-1989 enterprises had assumed more than one legal form since their inception, shifting status with incentives at the time. For example, many former cooperatives in the sample previously were economic working communities (GMKs and VGMKs).

24/ Throughout this report, firms that started operating since 1989 are referred to as new start-ups. Firms that operated prior to 1989 in the variety of enterprise forms listed here (taking new corporate forms in 1989) are referred to as pre-1989 firms.
A minimum understanding of these uniquely Hungarian enterprise forms, with some feel for how they operated, is helpful in understanding the dynamics of the current private sector. A brief characterization of each major enterprise form represented in the sample follows.22

**New Start-ups**

Represented by 27 firms in the sample, new start-ups were smaller than the sample average.26 Fifty-five percent of them had fewer than 20 workers and only 11 percent had more than 50 workers. Average monthly sales were US$46,000, 60 percent lower than the sample average. New start-ups accounted for 25 percent of firms but only 11 percent of total sample sales and 13 percent of exports. They were widely dispersed geographically with almost half in cities, more than a third in towns and almost 20 percent in villages. They manufactured a large variety of products with some concentration in clothing and machinery manufacturing.

None of firms classified as new start-ups were privatized state enterprises but about half traced their origins indirectly to state enterprises and cooperatives. Some took their state employer's best customers and workers when they left. Others set up companies to supply the state enterprise while they were still employed by the state firm. A good number of firms were created out of management quarrels among members of small cooperatives wherein a dissident group would simply form their own private company. Examples of these firms include a company founded by several members of a clothing cooperative who left and set up their own business, taking the cooperative's German buyer with them. Also typical was a man who took a group of workers and left his cooperative to set up a competing business when the cooperative voted to distribute all their profits instead of re-investing them.

Prospects were mixed for this group.27 They represented some of the strongest firms in the sample where entrepreneurs were dynamic and had established substantial export markets, and many of the weakest where entrepreneurs had inadequate technical and business skills. The weakest new start-ups typically were small firms with owners who were inexperienced in business, with little capital and few personal connections by which they could obtain raw materials and establish markets. The strongest new firms were run by highly capable owners with differentiated, good quality products and personal connections sufficient to ensure their inputs and their output markets. An example of a dynamic new entrant was an ice cream maker who worked previously in a large cooperative where he invented a process for making ice cream powder with a long shelf life that would prevent the common problem of salmonella poisoning. He left the cooperative and set up a private company in the Balaton resort area. At the time of the survey, he supplied about 70 percent of the ice cream powders in Hungary. Another

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25/ This section analyzes enterprise histories. Entrepreneurs' backgrounds cut across enterprise origins in that some entrepreneurs in new start-ups worked previously in pre-1989 enterprise forms. See Chapter III, Section "Entrepreneurship Development."

26/ Firms were classified as new start-ups if their ownership and their products were new regardless of the source of their factory buildings and equipment.

27/ Firms' prospects are discussed here to highlight the connections between enterprise histories and current performance. The criteria for classifying firms as weak or strong and more comprehensive analysis of the characteristics of strong and weak firms are contained in Chapter V, Section "Prospects: Strong Firms Vs. Weak Firms."
man took his long-ignored invention of a new process for making soy oil and set up his own business where he grossed 5.24 million forints per month with only eight employees.

Craftsmen

This group of 13 entrepreneurs started out as "craftsmen", operating legal and semi-legal small businesses in the late 1970s and the early 1980s that they transformed into limited liability companies following passage of the Association Law in 1989. Reflecting their years of operations, they were larger than the new start-ups with an average labor force of 48 and average monthly sales of $83,000. Almost 70 percent were located in cities. Like the new start-ups, they were clustered in clothing and machine manufacturing.

Prospects were unfavorable for many of these entrepreneurs: half said that production and profits had decreased in the previous months, and research teams judged that prospects for survival were poor for about 25 percent of these firms. As seen in Poland, pre-reform "craftsmen" started up in very different business environments, and their survival in the new post-reform environment often depended on their ability to re-orient their production to the new demand structure. Some were not well-equipped to make the transition; others showed signs that they were adjusting.

An excellent example of the independence and initiative of some early craftsmen was a couple who began as gym teachers and theater buffs and who went on to sew gym clothes in their home, selling them in an unfilled market niche. In the early years, they had difficulty obtaining the types and quantities of inputs they needed, and they reported paying off many retailers to get what they needed. They transformed their enterprise into a limited liability company in 1989. When they read of a World Bank line of credit, they paid a state enterprise 70,000 forints to help them fill out the forms, and they received a loan of 7.2 million forints. Their factory now occupies 1,000 square meters, and they have more orders than they can fill.

Privatized State Enterprises

Thirteen sample enterprises were privatized state companies. Some took over divisions or entire state enterprises and cooperatives where they worked previously, purchasing or leasing the buildings and equipment from the state. In several cases, large state enterprises sold small divisions to groups of workers. Also typical were former divisions of huge state enterprises, offered for sale after the state firm had splintered into smaller parts under orders from the government in the late 1980s. In most cases, the enterprise or division was failing at the time of purchase. Most entrepreneurs in these firms were experiencing substantial difficulties re-orienting production to the new environment. Key to their abilities to restructure were their own level of technical and business skills, the flexibility of the capital stock that was purchased, and access to credit for new investment.

An example of a privatized firm comes from the famous, mid-19th century Ganz company that built the first modern bridges across the Danube, among many other achievements. The government ordered the huge company broken into seven smaller firms in 1987 and saddled each with a share of the larger company's debt. When the steel company went bankrupt in May 1990, the government sold off its component parts to pay its creditors and our sample entrepreneurs and nine workers bought the light metal fabricating division and set up shop. These entrepreneurs displayed tremendous motivation and sound technical skills to create a successful company from the ruins they had purchased, but their success was highly dependent on their ability to locate new markets, manufacture new products, and incorporate the principles of flexible production.
Twenty-nine sample firms previously were economic work partnerships (VGMKs and GMKs), quasi-private, pre-1989 industrial enterprises that operated within and in close association with state enterprises. An important characteristic of these enterprises was that their membership consisted of the elite of Hungarian industrial workers. GMKs (the more numerous of the two groups in the sample) could choose their own products and sell to whomever they could find, but they were limited by available equipment and the wages workers could be paid. In some cases, GMKs operated within state enterprises making similar products and employing workers from the state factory. In other cases, they were merely facades for purely private businesses. An example of the first situation was a manager from a failing state enterprise that produced church organs who started up a GMK within the state enterprise to repair and service organs. When the state company failed, he and his partners bought equipment from the state enterprise and started producing organs. An example of the latter situation was found in a print shop that paid a sports club a fee to operate under its umbrella.

Along with the transformed small cooperatives, former GMKs clearly were the powerhouse of the sample. These firms were relatively small as judged by their average work force: 95 percent had between 20 and 50 workers. But at US$196,000, their average monthly sales were nearly twice the sample average of US$109,000. They were located in urban areas: 70 percent in cities and 20 percent in towns. With few exceptions, they produced plastic and metal products and machinery. Their ties to the state sector remained strong as shown by the fact that virtually all of their domestic sales went to the state sector, whether for intermediate or finished goods. Research teams judged that prospects were promising for 60 percent of these firms, unclear for 30 percent, and poor for only two enterprises in this group. Their primary constraint was lack of demand for their products, typically because their state customers were in trouble. As was the case with privatized state firms, many entrepreneurs in these firms were faced with the necessity of restructuring their production to respond to new business conditions. Most were doing so, and their high level of dynamism, strong technical skills, and solid networks of personal connections indicated that many would succeed.

Small Cooperatives

Twenty-two sample firms were transformed small cooperatives and, similarly to the GMKs, some were prosperous and strong. They were small in terms of workers—75 percent reported work forces of fewer than 50—but relatively large in terms of sales with average monthly sales of almost US$250,000, more than twice the sample average. Prospects were mixed for these firms. Researchers judged that 40 percent had strong odds of success in the future, but another 40 percent were evaluated as having poor prospects. Many of the high performers were exporting; a striking one third of small cooperatives' sales were exported. Problems in the poor performers were due to needs for restructuring the declining state sector upon which most depended, and increasing competition from other private firms.

The history of one company manufacturing construction materials stood out as an example of how small cooperatives developed over the years in Hungary leading up to their most recent incarnation as limited liability companies. This firm was established in 1952 as a cooperative engaged in construction. In the early years, management was appointed and the cooperative was given a quota of apartment

28/ The numbers of firms cited in this section exceed the number in the total sample as many pre-1989 enterprises had histories both as GMKs and small cooperatives. Figures on average sales and labor forces for GMKs and small cooperatives therefore inevitably count some firms twice.
buildings to be built. Prices per square meter were set, but cost overruns did not pose problems as profit-making divisions of the cooperative covered the costs of those making losses. When five-year plans were initiated, cooperative representatives bargained quotas down to leave time for additional jobs, in part to cover the losses incurred from the government quotas. Average salaries and the percentage of annual average salary increases were fixed, a practice which led to overemployment of unskilled labor needed in order to pay skilled labor at higher rates.

The reforms of 1968 brought more autonomy. Members now elected their president and had more freedom to choose their customers, including turning down government jobs. The bidding system was introduced and cooperatives bid against one another, targeting the most lucrative contracts. In 1982, the shift to "small cooperative" status brought even more autonomy in wages setting, lower taxation, and more involvement in foreign trade, although all external trade had to pass through state trading companies. Cross-financing among divisions of cooperatives ended and, with passage of the Association Law, many divisions of small cooperatives incorporated and became limited liability companies. This particular manufacturer was the manager of a loss-making division producing construction materials that split off from the parent small cooperative. The enterprise was earning high profits as a supplier for state construction firms. The connections were in place; the skills and experience were honed over 40 years; and the freedom to operate independently was well-practiced. The work force dropped from 330 workers to 186 in two years, and sales rose from 60-70 million forints per year to 186-220 million.

**Industrial Divisions of Agricultural Cooperatives**

Characteristics of the 14 sample firms that previously were industrial divisions of agricultural cooperatives reflected their histories as cooperatives closely associated with the state. These firms produced traditional products, mostly in plastics and metal. They were larger than other sample firms in terms of numbers of workers—almost 60 percent had more than 100 workers—but much smaller in terms of monthly sales which averaged US$60,000. Workers in these firms were paid an average of only US$160 per month, close to salaries in former craftsmen enterprises and far below the sample average of US$203. Production equipment was old, with a value-weighted average of almost 13 years as compared with 8.6 years for the sample as a whole. Prospects were poor for many of these firms, mainly because they depended largely on the state sector to buy their products. In fact, a third of entrepreneurs in these firms reported that lack of payment by state enterprises was their single biggest problem. Almost 80 percent said that production volume had remained at the same level or had decreased in the previous several months, and almost 50 percent said that their profits had decreased during the same time period.

In some cases, industrial divisions used the parent agricultural cooperative for legal shelter; in others, the cooperative used the industrial division to subsidize losses in the agricultural divisions; and in others, the divisions co-existed as intended. For example, one small company that produced hospital linens started under the umbrella of an agricultural cooperative in 1985, choosing this form over the GMK and the small cooperative because this form brought with it less responsibility. The cooperative took 60 percent of the enterprise's revenues but in return, guaranteed product orders, procured and paid for all raw materials as well as energy costs, and kept the enterprise's accounts. The enterprise paid all labor costs and repair bills. When the enterprise took up the status of a limited liability company in 1990, they purchased the equipment from the cooperative and continued to use the same input and output channels.

In sum, the sample was dominated by pre-1989 enterprises in terms of numbers of firms and contribution to sales and exports, but winners and losers were found within both new and old firms. Prospects for pre-1989 enterprises generally depended on their owners' abilities to restructure production;
prospects for new enterprises depended on their owners' abilities to mobilize start-up capital, forge channels to secure inputs, and locate new markets. Cutting across groups, a generalization would be that privatized state firms, traditional "craftsmen", industrial divisions of agricultural cooperatives, and inexperienced new start-ups faced the largest obstacles to success and were judged to have the poorest prospects. The strongest firms in the sample were new firms led by dynamic entrepreneurs (some of whom worked previously in GMKs) who had entered export markets, and former GMKs led by technically proficient entrepreneurs with an invaluable network of personal connections. Small cooperatives were evenly split between strong exporters and weak firms that were declining with the state sector.

Capital

Physical Capital

Hungarians were keenly aware that with more modern equipment, they could improve quality, productivity, and profits, but most could not afford the expense without Western investors. Only 39 percent of production equipment (in value terms) was produced in Hungary, 40 percent in Western countries, and 21 percent in former CMEA countries. As expected, new start-ups (particularly textile and clothing companies) were twice as likely to have Western equipment (German and Japanese) than were pre-1989 firms (particularly metal-working and machine shops).

Except for a few electronics firms and several entrepreneurs with foreign partners, few sample firms had entirely new equipment. A quarter reported that their machinery averaged less than three years, but equipment averaged 10 years or more in another quarter of firms. The average value-weighted age of equipment for all firms was 8.6 years. Equipment in new start-ups was, on average, far newer than that of pre-1989 firms (5.9 years vs. 9.3 years). Equipment was most dated in metal working and plastics firms—dominated by older, larger firms—and newest among clothing, machinery, and specialty products manufacturers, the sectors of choice for new start-ups. Larger firms (with > 50 workers) were using equipment that was several years older than the sample average and of far greater average value. The average replacement value of equipment per firm was US$320,500, much higher than the average of US$132,321 in Poland and substantially higher than the average of US$244,537 in CSFR.29

Most entrepreneurs leased their machinery (and their factory buildings) from state firms and cooperatives that had closed down, were in financial trouble and in search of capital, or were seeking avenues for acquiring equity in new private enterprises. The market for leased equipment appeared highly imperfect: competition was slim; buyers and sellers were poorly informed; investment capital was scarce; and usually one or both parties was under duress. Most owned some equipment and leased the rest, but some had long-term leases on entire production lines that belonged to defunct state enterprises or cooperatives.

Leasing terms varied widely. Many had informal leasing arrangements (some involving equity arrangements) with the state enterprise or cooperative from which they had originated, and others leased equipment on a temporary basis from other private firms or private individuals in conjunction with subcontracting arrangements. Rates varied from only 2 percent of the reported present value to almost half. In a few cases, firms were working like maquiladoras, using foreign customers' equipment on

29/ Entrepreneurs were asked the replacement value of each major piece of equipment in use. In almost all cases, entrepreneurs were keenly aware of the current market value of their equipment.
lease/purchase terms. These entrepreneurs complained that they were subjected to unfair conditions by their foreign partners, but most also acknowledged that lease/purchase arrangements were their only options for obtaining modern equipment.

**Finance**

Free enterprise came before modern financing mechanisms in Hungary. Without venture capital, stock markets, investment banks, or collateral, most Hungarian entrepreneurs had reached into their own pockets to start their businesses. Only 9 percent had loans during the first six months of operation. By the second six months, success had enabled 43 percent to use cash flow for developing their businesses. Eleven percent of firms had loans after six months of operating, increasing to 19 percent after the first 12 months as entrepreneurs leveraged their earnings into credit ratings (Chart 4.3).

Chart 4.3: Sources of Funding Used by Hungarian Entrepreneurs

Hungarian entrepreneurs had received a comparable number of bank loans to their counterparts in Poland and CSFR, but the time frame within which they received them differed. Since start-up, a total of 43 percent of firms had received short-term loans, 17 percent had gotten long-term loans, and 14 percent had received both. By comparison, 57 percent of Polish entrepreneurs received working capital loans and 11 percent investment credits, and 17 percent of Czech and Slovak entrepreneurs had obtained short-term credits and 55 percent had long-term loans. But Hungarians who received loans obtained them much later in the lives of their firms than entrepreneurs in Poland and CSFR. A quarter of Hungarians
had received loans after three years in business; two thirds of Czech and Slovak entrepreneurs had received loans within six months.

Entrepreneurs who had received short and long-term loans from banks matched the profile of the sample as a whole remarkably closely, e.g., the majority were new start-ups, former GMKs, and small cooperatives located in cities and towns. Few craftsmen or industrial divisions of agricultural cooperatives had obtained loans. Twenty-eight percent of sample firms had never applied for a loan, and even successful applicants thought current interests rates prohibited financing their businesses with further credits.

**Labor**

*Size and Gender of the Labor Force*

The average full time labor force was 44 workers. The largest firm had 437 workers. New start-ups were the smallest firms with 55 percent reporting 20 or fewer workers, and the descendents of former cooperatives (small cooperatives and industrial divisions of agricultural cooperatives) were the largest with almost a third of both groups reporting more than 50 workers. Clothing manufacturers and machine shops were the smallest firms, and producers of plastics and metal goods were the largest. Not surprising, the largest firms were in the cities and in rural areas (where many former cooperatives were located). The largest concentration of small firms with 11-20 workers was in small and medium towns where many new start-ups were found.

Women participated in this new work force in equal numbers with men. While almost every firm employed both men and women, activities were almost always clearly divided into men's jobs and women's jobs. With the exception of furriers, women held almost all production line jobs in clothing firms while their supervisors tended to be men. Wage figures analyzed by sector show that in the knitting and apparel industries where the work force was mainly women, the average salary per worker was 20 percent less than the average for other sectors in the survey. Men held almost all of the jobs in metal working and machinery production. With the exception of the 12 women entrepreneurs interviewed--some of whom were members of husband and wife teams--men held the positions that determined company policy and spending. Most of the women who worked in management kept company books and did design work. Despite clear differences in position and pay, women workers and managers questioned about gender issues almost unanimously said they faced no special barriers to their business activitias.

*Labor Compensation*

Some notion of a "just wage" prevailed among entrepreneurs, generally based on paying higher salaries than the state sector and on differentiating between earnings of skilled and unskilled workers. The average monthly wage paid by sample firms was US$207 with an average total monthly cost per worker of US$330 and average cash or in kind benefits of US$45. Wages differed substantially according to sector with workers in machine shops earning 40 percent more than those employed by clothing manufacturers, a differential that likely is linked to the greater skill of machine manufacturers. Rural firms paid a lower average salary of US$184 with higher average benefits (usually associated with transportation) of US$56 (Table 4.4).
Table 4.4: Labor Costs g/
(US$ Per Month)

<table>
<thead>
<tr>
<th></th>
<th>All</th>
<th>City</th>
<th>Town</th>
<th>Rural</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total per worker (wages, taxes, benefits)</td>
<td>$330</td>
<td>332</td>
<td>323</td>
<td>303</td>
</tr>
<tr>
<td>Salary net of taxes and benefits</td>
<td>$207</td>
<td>210</td>
<td>205</td>
<td>184</td>
</tr>
<tr>
<td>Benefits paid directly, cash or in kind</td>
<td>$45</td>
<td>41</td>
<td>37</td>
<td>56</td>
</tr>
</tbody>
</table>

g/ The exchange rate used was 74 forints = US$1.

Entrepreneurs reported that higher salaries in the private sector were, in part, offset by fewer fringe benefits. Typical was a private textile factory that paid salaries of 15,000 forints per month and no benefits compared with state textile factories that were paying 8,000 forints per month plus lunch, transportation for commuters, and vacation houses. Benefits offered to workers in Hungarian sample firms accounted for just over 20 percent of wages, compared with a high of 32 percent in Polish sample firms and a low of 7 percent in Czech and Slovak sample enterprises. In addition to the two weeks vacation and extended maternity leave provided by law, some private producers supplemented workers’ non-taxable income with modest allowances for transportation, housing, and work clothing, use of vacation homes, a thirteen month’s salary, tool allowances, and production bonuses. Non-monetary benefits occasionally included use of enterprise machinery for after-hours work, interest-free loans, and wholesale procurement of consumer goods.

Market forces clearly were beginning to produce greater differentiation between the salaries of skilled and unskilled workers. Employers were instituting incentive pay plans, and some highly skilled workers were beginning to see wages rise rapidly. One Budapest producer of medical electronics paid his research and development staff workers about $550 a month. Most of them were under thirty. A producer of welding equipment paid his machinists $500 a month. In many industries, especially clothing, piece work was common.

Both workers and employers commonly participated in schemes to evade labor and social security taxes which totalled 44.5 percent of wages. Indeed, the actual average tax rate paid for labor for the sample as a whole was 38 percent. Tax evasion took a number of forms. In many cases, lower tax rates were obtained through subcontracting and part-time employment. In apparel and crafts industries, employers commonly hired home workers as subcontractors for whom labor taxes were not levied. For example, 20 of 33 employees of a Budapest maker of leisure clothes were cottage workers. Where home workers used their own machines, an additional tax-free 30 percent was added to the subcontracting fee for equipment leasing, thus saving the entrepreneur about 15 percent in labor taxes. For example, one clothing producer signed contracts with a German buyer to deliver women’s clothing and then subcontracted with two cooperatives to produce the clothing, paying the 30 percent machinery fee but saving the wage taxes. One printer had six full-time employees in the office and seven part-time people at home, saving space and labor taxes. Also typical were producers who leased workers along with buildings from cooperatives, thus avoiding payment of labor taxes. Another practice was to operate a portion of the business in another legal form that levied lower taxes. For example, a steel fabricator avoided a good portion of labor taxes by doing 50 percent of his business as an unlimited partnership (BT) where workers are members and labor taxes are only 10 percent.
Labor Skills and Training

Unskilled workers were plentiful, skilled workers often hard to recruit. Well over half of entrepreneurs reported that they had trouble finding the skilled workers they needed, but fewer than 10 percent complained of problems recruiting unskilled workers. Growing unemployment in Hungary seemed to provide an abundant source of unskilled workers, although many employers complained that they brought poor work habits with them from the state firms where ineffective incentives, job security and a pervasive dislike for the government had resulted in poor motivation for productive work. Skilled workers were scarce due to a general shortage of skilled labor in Hungary, because state enterprises were trying to retain them, and because many were forming their own private companies.

Entrepreneurs complained that workers' skills were narrow and outdated. They faulted Hungarian vocational training schools for delivering training that is too narrow for the flexibility needed by workers in new private factories. Training on old machines reportedly has produced workers unprepared to work with more modern equipment and afraid to try. Several entrepreneurs commented that the low salaries paid to teachers were responsible for the low quality of training offered. In sum, producers' appetite for new technology appeared to be rapidly outpacing the educational system's ability to prepare workers appropriately.

Labor Representation

Labor unions were still associated with communist party ideology, and employers thought it hilarious that interviewers asked if their workers bargained through a union or council. Asked why there were no unions, most employers shrugged and responded there was no need. An exception was one large dye-maker, with a portrait of Lenin still hanging behind his desk, who said he had insisted his workers have a union because unions could more easily deal with workers' personal and social problems than management could.

Land and Buildings

Entrepreneurs had set up production in all kinds of buildings and locations from regular factory buildings in industrial areas to former chicken coops, garages, and single family homes in residential areas. Sixty-five percent of entrepreneurs leased their land and factory buildings, mostly on a multi-year basis. Most entrepreneurs were able to locate and lease factory space without excessive difficulty, but many faced serious obstacles to purchasing their space, and the quality and price of available space for lease varied widely. Almost half of entrepreneurs said that their production spaces were too small or of poor quality but better space was either not available or was too expensive. Many entrepreneurs had responded to the limited supply of affordable factory space by splitting their production into several locations with obvious sacrifices in efficiency.

By comparison with other sample countries, ownership rates among Hungarian entrepreneurs were twice those among Polish entrepreneurs but far short of the 45 percent observed in Czechoslovakia, where the small privatization program has proved to be an efficient means of transferring state property into private hands. The relatively low ownership rate of 28 percent reflected a pervasive scarcity of capital and the slowness of local and national governments to clear up title problems, value state-owned property, and approve sales. At the same time, it must be noted that leasing was advantageous to some entrepreneurs who were short of capital. Almost all former cooperatives were leasing their buildings under arrangements that, for the most part, appeared favorable. Other entrepreneurs, particularly those leasing from state firms in industrial areas, were anxious to purchase their buildings but were stymied
by lack of capital or by delays in granting approval by the State Property Office. The most immediate result of leasing rather than owning their building was a lack of collateral to secure bank loans.

In the turmoil of the first years of transformation, real estate leases were negotiated without the benefit of regional or national norms or a foundation in leasehold appraisal wisdom. The survey did not methodically collect leasing terms, but sporadic sampling revealed a wide variety of lease conditions. Many producers had to do extensive remodeling, and they had negotiated low rents as compensation from owners who could not afford leasehold improvements. Others may have received favors from government or exploited connections with state enterprises. Real estate, in any event, was a very unlevel playing field for the two thirds of private producers who leased their property.

Intermediate Inputs and Raw Materials

The state sector remained the primary source of intermediate inputs and raw materials for sample firms, with 74 percent (by value) of all inputs purchased from state firms and 26 percent from private suppliers. Similarly, 69 percent of inputs (by value) were produced domestically and 31 percent were imported. Interestingly, most imported inputs were purchased from state companies (mainly state trading companies), unlike in Poland where almost all imported inputs were sold by private retailers.

The source of inputs depended largely on sector. Clothing firms relied on imports for almost half their inputs, and plastics firms used mostly domestic inputs from the state sector. Inputs in small firms with 1-10 workers were almost 90 percent domestically produced and purchased from state enterprises. Pre-1989 enterprises (craftsmen and industrial divisions of agricultural cooperatives) bought most of their inputs from state enterprises. Almost half of inputs purchased by new start-ups were imports.

Product Markets and Distribution

Analysis of product markets shows the increasing importance of the private sector in Hungary's economy. When asked the identity of their primary customers, 44 percent of entrepreneurs said that they sold mainly to state enterprises, half intermediate goods and half finished goods. Twenty-nine said that they sold mainly to private firms: one-third, intermediate inputs and two-thirds, finished goods. An additional 24 percent sold a mix of intermediate and final goods directly from their shop to both private and state customers. Exporters sold directly to private customers abroad and to state trading companies.

| Table 4.5 Product Markets by Sector (Percentage of Responses in Each Category) |
|---------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
| Total Responses                | Knitting | Clothing  | Plastic Product | Metal Product | Machinery | Other |
| Primary markets                |           |           |               |              |           |         |
| Sell directly from shop        | 24        | 17        | 29           | 20           | 26        | 23        | 25        |
| SOEs (inputs)                  | 20        | 17        | 0            | 33           | 35        | 23        | 12        |
| Private firms (inputs)         | 9         | 33        | 7            | 7            | 4         | 6         | 12        |
| SOEs (finished goods)          | 21        | 0         | 36           | 20           | 22        | 18        | 21        |
| Private retailers              |           |           |               |              |           |         |           |
| (finished goods)               | 14        | 17        | 21           | 7            | 4         | 12        | 21        |
| Govt. (finished goods)         | 2         | 16        | 0            | 7            | 0         | 0         | 0         |
| Private middlemen, agents      | 4         | 0         | 7            | 6            | 4         | 6         | 6         |
| Others                         | 6         | 0         | 0            | 0            | 5         | 12        | 3         |
Product markets were largely a function of firms’ histories and their activities. New start-ups, particularly clothing and knitting firms, sold proportionately more to other private firms and to private trading companies than did other firms. As expected, pre-1989 enterprises relied mainly on their old customers in the state sector although they too were actively courting new private customers. For example, many metal and machine shops that formerly were GMKs and industrial divisions of agricultural cooperatives continued to fill orders from state enterprises when they could get them, but they also were selling small, custom orders from their own shops to a mix of customers.

Exports

Forty-five percent of entrepreneurs were exporting. A third of exporters were selling more than half of their production abroad. In value-weighted terms, a remarkable 36 percent of total sample sales were exported. Ninety-nine percent of exports sold for hard currency, with only 5 percent of exporting firms reporting some portion of their sales in rubles.

Fifty-seven percent of exporting firms sold directly to foreign buyers. Direct contracts with foreign buyers commonly resulted from previous professional contacts or from personal connections. In a number of cases, entrepreneurs were able to sign contracts with foreign contacts established when entrepreneurs were managers in exporting state enterprises or GMKs. In other cases, entrepreneurs had made contact with foreign buyers through business trips to Western Europe designed specifically to identify foreign markets, or through family and friends abroad. For example, the owners of a new company producing kayaks travelled abroad under a contract with a state enterprise that exported kayaks. Well aware of product requirements on the world market, these owners were able to secure investment capital from an Hungarian in Australia and establish their own successful export company based on previous contacts.

The remainder of exporters exported through intermediaries. Many relied on state trading companies that relayed foreign orders to the manufacturer and contracted to buy the finished products at pre-agreed unit prices. About 20 percent of exporting firms had subcontracting relationships with foreign buyers. In these cases, the foreign company would supply the Hungarian firm with product specifications and raw materials (sometimes semi-processed) and contract to purchase a given number of units at pre-set prices. Often such arrangements were used by Hungarian entrepreneurs to obtain new production machinery on a lease or lease/purchase basis.

A good example of a subcontracting arrangement was found in a former small cooperative making plastic garbage bags that had found a German partner that took a 40 percent equity share. The German company provided the raw materials with an interest-free supplier’s credit of 80 days, and guaranteed purchase of 80 percent of the production. The German company brought in new production equipment and leased it to the Hungarians with the option to purchase in seven years. The manager of the Hungarian company complained that the Germans overcharged them for the inputs and squeezed their profits by offering low prices for the final goods, but he conceded that the arrangement, particularly the lease/purchase option on the equipment, was the only means for the cash-poor cooperative to stay afloat and to build an asset base.

A number of differences emerged when exporting firms were compared with non-exporters. Exporting firms were larger than non-exporters: 37 percent employed over 50 workers as compared to only 10 percent of non-exporting firms. Pre-1984 enterprises, particularly former small cooperatives, accounted for 83 percent of exports. Exporters were distributed across the country in proportion with
the sample as a whole. Sectoral differences were insignificant. Products ranged from extruded plastic bottles and apparel to higher value machinery and parts.

Trends in Production and Profits

Some firms were declining, but the majority reported stable or increasing output and profits. Specifically, 40 percent of entrepreneurs reported that output had increased in the previous three months; 21 percent said that output had remained the same; and 36 percent that it had decreased. Increases in production were led by machine shops with 1-10 workers and 21-50 workers. Across the sample, entrepreneurs with 11-20 workers reported the slowest growth in production. Clothing, metal, and plastics firms saw proportionately greater declines in production. Urban entrepreneurs were more likely than rural firms to report increasing production.

When asked whether their businesses were more or less profitable than in the first few months following start-up, 61 percent of entrepreneurs reported that they were earning higher profits; 7 percent that profits were unchanged; and 32 percent said that profits had dropped. More machinery manufacturers reported increases in profits than entrepreneurs in other sectors; metal and plastics manufacturers more often than others described falling profits.
V. THE BUSINESS ENVIRONMENT: CONSTRAINTS AND PROSPECTS

Section A of this chapter identifies and analyzes the constraints cited most often by entrepreneurs. Section B contains a brief overview of the business environment, highlighting several aspects that appeared to favor private producers and several that worked against them. In Section C, a group of strong firms is compared with a group of weak firms to identify variables associated with success.

Main Constraints

Two issues dominated when entrepreneurs were asked to name the biggest problems affecting their businesses: inadequate finance and soft product demand. Problems with finance were the major constraint for 54 percent of entrepreneurs. Specific problems included: (i) lack of available bank credit for investment and working capital (cited first by 20%); (ii) diminished demand for their products (19%); (iii) delinquent payment by state enterprises for goods delivered (14%); (iv) high interest rates for bank credit (12%); and (v) difficulty in dealing with banks (8%).

Access to Institutional Credit

One in five Hungarian entrepreneurs cited lack of access to credit as the single largest problem affecting his/her business. Specifically, sixteen percent said that they had no access to needed working capital loans and 4 percent cited lack of access to investment credits.

At a general level, researchers encountered pervasive ill-will when the subject of bank credit was discussed. Three quarters of respondents said that loans were difficult to obtain, and almost all thought credit was unreasonably expensive. Many were of the view that those with strong personal connections and the ability to pay off loan officers had preferential access to loans and more favorable credit terms. As one entrepreneur put it, "Who sits by the fire, gets all the heat."

Although most entrepreneurs had problems maintaining adequate finance, researchers were impressed with the high level of innovation and flexibility that entrepreneurs employed with available resources. The following strategies for stretching scarce capital were common:

(i) Many entrepreneurs shifted fluidly from production to subcontracting, abandoning their own production temporarily for someone else's when they could not finance their own raw materials or when orders were thin. For example, a thread manufacturer periodically subcontracted his production to a sweatshirt manufacturer who provided the yarn and the opportunity for the manufacturer to keep his workers and make a small profit on the labor costs. In fact, 60 percent of this company's throughput was subcontracted out to other producers (who also worked part-time as subcontractors).

(ii) Many maintained their own production but subcontracted for much of their labor, typically to individuals who worked at home. These entrepreneurs avoided purchasing production equipment—usually sewing and knitting machines and metal-working equipment—by hiring workers with their own machines. Entrepreneurs simply added a small lease amount to the labor bill and escaped a large capital investment as well as steep labor taxes (subcontracted labor is exempt from labor taxes).

(iii) Some entrepreneurs had brought in foreign partners who contributed much-needed capital, often in the form of new equipment provided on a lease/purchase basis. Typical was the case of a plastics producer who sold 20 percent of his company to an Australian investor in 1990 to raise capital and take advantage of tax breaks available then only to joint ventures. In another situation, a sanitary garments
manufacturer benefitted enormously from her foreign partner who provided her with a loan to lease her building and to buy modern Japanese sewing machines, and paid in advance for orders until her cash flow was sufficient.

(iv) Unlike in Poland and in CSFR where private producers had to pay cash for inputs from state enterprises, some Hungarian entrepreneurs—particularly in pre-1989 enterprises—were able to participate in an extensive inter-firm credit network that still prevailed in September 1991. Known as "lining up", managers in state firms are members of an informal credit system in which credit is extended from one enterprise to the next, from suppliers of raw materials to retailers of the final product.

(v) Entrepreneurs compensated for shortages of investment capital by extensive leasing of production facilities and equipment. As stated above, 65 percent of entrepreneurs were leasing their buildings, and many entrepreneurs leased their equipment from state enterprises, cooperatives and foreign partners. In some cases, leases from state enterprises were temporary measures until sales were approved by the State Property Office.

(vi) A number of other strategies were observed. Some spin-offs from cooperatives had turned back to the cooperatives for loans and for equity participation. Several firms were involved in barter arrangements with their customers. For example, a wood-carving company had arranged for a furniture factory with delinquent accounts to deliver furniture in lieu of payments. In effect, the furniture maker was paying off his debt with labor on which the carver made a profit. Some had worked out credit arrangements with friends who also were suppliers; others had turned to relatives and friends abroad.

In sum, most entrepreneurs had exploited every source of potential financing and were stretching scarce capital as far as possible. But costs often were high. Lining up raw materials and the means for paying for them reportedly took an exorbitant amount of time, and sometimes it proved impossible. Researchers observed a number of situations where entrepreneurs were unable to fill in-hand orders because they could not arrange financing for needed raw materials. Some entrepreneurs had paid far more for their inputs than they would pay if they could finance bulk purchases. Many were operating with substandard equipment because they had no access to investment credits. In some cases, sub-optimal partnerships were formed purely on the basis of capital requirements. Leasing instead of purchasing facilities, arranging for semi-legal subcontracting production, and relying on informal loans and credits had left some enterprises with books that showed their companies to be far smaller and weaker than they were, a serious liability when approaching a bank for a loan. In addition, workers for whom social security taxes were not paid obviously would face a time when needed benefits would not be available.

**Issues of Demand**

Analysis of the 19 percent of entrepreneurs who cited weak demand as the largest problem affecting their business revealed a clear pattern. Most firms facing weak demand had four characteristics in common:

(i) They were more likely to have been pre-1989 enterprises than new start-ups, mostly GMKs and industrial divisions of agricultural cooperatives;

(ii) Most relied on state enterprises as their primary customers;

(iii) Machine manufacturers and metal workers dominated, with 35 percent and 29 percent of each group, respectively, reporting lack of demand as their biggest problem;
(iv) Thirty-five percent were located in towns compared with 15 percent in cities and 12 percent in rural areas.

In sum, a number of firms that began as quasi-private enterprises inside and around the state enterprise sector in the 1980s were facing demand problems as their state clients were cutting back and re-structuring. Most produced intermediate machinery, plastics, and metal inputs for the state sector. Entrepreneurs in towns complained of dwindling demand more often than those in rural areas and cities, perhaps because villages contained few state enterprises and more niche opportunities, and cities offered broader market opportunities.

**Competition.** In sharp contrast to Polish entrepreneurs whose demand problems were due mainly to their inability to compete with a flood of imports, problems with soft demand reported by Hungarian entrepreneurs were almost entirely unrelated to the level of competition they faced. Instead, diminishing orders in most demand-constrained firms stemmed mainly from cutbacks among state-owned customers rather than from large numbers of new entrants. For example, 35 percent of machine manufacturers cited lack of demand as their top problem, but few reported any significant competition. Rather, they reported that their orders had dropped off when their primary customers, state enterprises, had cut back. Similarly, clothing, knitting and plastics producers faced relatively large numbers of competitors, but they complained little of lack of demand for their products. The exceptions to this pattern were metal producers who suffered both from cutbacks in orders from state enterprises and from large numbers of new metal shops.

In general, the level of competition faced by Hungarian entrepreneurs appeared moderate and growing, far lower than in Poland but substantially higher than in CSFR. Specifically, 50 percent of entrepreneurs competed with 10 or fewer other firms in their main markets, but over 70 percent said the number of competitors in their markets had grown since they started up. Further evidence that competition (or corruption) was growing was seen in the apparently widespread practice of offering a bribe of 2-4 percent of an order to prospective buyers.

The main sources of competition were other small private firms (cited as the main competitor by 29% of firms) and state enterprises (cited by 28% of firms). Only 11 percent of entrepreneurs—as opposed to 24 percent in Poland and only 4 percent in CSFR—cited imports as their main competitors. The most serious competitors were other private firms. As seen in Poland and CSFR, most entrepreneurs were confident that they could undersell their state competitors by exploiting their own greater efficiency and flexibility.

The surprising lack of import competition was attributable to several factors, most notably limitations in access to foreign exchange among individual traders (the force behind Poland's booming import trade); slow progress in privatizing Hungary's retail sector, and the inability of state trading companies (which continued to dominate foreign trade in Hungary) to cater to consumer preferences. Those who did compete with imports felt confident that their product quality was comparable and their prices lower. They distinguished between Western products which they could undersell, and Asian products where Hungarian quality won out. The more astute entrepreneurs were anticipating growing import competition. For example, one couple producing bed sheets for hospitals knew that the quality of cloth available to them in Hungary was below that of imports and, thinking ahead, they had already attended a trade show and made contacts for wholesaling cheaper, imported linens from China and Egypt when imports enter Hungary in force.
Activities with the lowest entry barriers faced the most intense competition, estimated by asking entrepreneurs the number of other firms producing in their main markets. Most machinery manufacturers reported that they either had no competition (30%) or fewer than 10 competitors (53%). By contrast, 40 percent of clothing, knitting, and plastics firms reported that they had more than 100 competitors, presumably because entry costs were low.

**Delinquent Payment by State-Owned Enterprises**

Similarly to entrepreneurs in Poland and the CSFR, slow payment and non-payment by state-owned enterprises (SOEs) for goods delivered had created serious problems with working capital for many Hungarian entrepreneurs, and was rated as their single biggest problem by 14 percent of the sample. Virtually all firms that relied on SOEs as their major customers were affected negatively by delayed payments. As described above, some Hungarian entrepreneurs were able to preserve their working capital by using personal connections to secure raw materials from SOEs on credit. The majority, however, were without personal connections and thus were caught in the bind of paying cash for raw materials but extending 90-120 days credit to state-owned buyers. Several had taken delinquent SOEs to court, but they reported that the process typically took a year or more by which time the offender might well be bankrupt. Many railed against the government for allowing such laxness and for failing to provide effective debt recovery mechanisms. They were particularly incensed by the additional fact that inflation rates of 30 percent effectively reduced the purchase price by 15 percent when payment was delayed by six months.

**High Interest Rates**

The fourth biggest problem, cited by 12 percent of entrepreneurs, was high interest rates. An analysis of real interest rates shows that indeed they were at highest point of the previous year in August 1991, the month preceding the survey. Considerations of whether real interest rates were unreasonably high include the following. First, rates are based on expectations of trends in inflation, and expectations were that inflation would rise. Second, bank officials presumably view lending to small and medium businesses as high-risk ventures. Third, lending to private business is new to Hungarian banks, and it can be expected that banks will move only slowly to admit this new clientele.

Nonetheless, many entrepreneurs expressed the view that banks were exploiting them with high interest rates. Lower rates reportedly were available for those who hired unemployed people, set up operations in under-developed areas, started up businesses as result of being unemployed, and kept their loan request under specified amounts. Differential rates led to accusations that bankers gave their friends cheaper rates than were available to the general public.

**Difficulty in Dealing with Banks**

A closely related problem was difficulty in working with banks, cited first by 8 percent of respondents. Entrepreneurs complained about many aspects of banks' operations, but excessive loan requirements were most common. Collateral requirements, reportedly 150-200 percent of loan amounts, were cited as the largest impediment to obtaining loans and the most unfair banking practice given that relatively few entrepreneurs had the opportunity and sufficient capital to purchase factory buildings, the security preferred by banks. Some entrepreneurs had tried but failed to use in-hand orders as security in lieu of collateral, failure that had led to loss of the orders in some cases. For example, one large plastic bottle producer secured an order worth 100,000 forints from Scandinavia but could not fill it because he was unable to get a loan to purchase the machine needed to upgrade to the required quality.
Other entrepreneurs had approached banks with business plans but found loan officers unwilling to extend loans on that basis. Tactics to evade taxes had backfired on some entrepreneurs whose earning potential appeared less promising than was the actual case.

The process of obtaining loans from banks apparently involved clearing large number of hurdles. Most entrepreneurs had hired attorneys to prepare complex loan applications, often paying fees of 3-5 percent of the loan amount. Loan amounts reportedly were limited to three times firms' start-up capital. Many entrepreneurs started with the minimum requirement of one million forints, and they thus were limited in loan size to three million forints. One entrepreneur had a cash flow of 200 million forints but could qualify to borrow only 3 million forints. Several reported that their banks required that they maintain operations for 18 months before loan applications would be considered.

The existence of many different credit programs, some with preferential interest rates associated with special incentive programs, may have led to more discord and red-tape than benefits. Several entrepreneurs had successfully obtained loans through the Start program, but one entrepreneur characterized this program as "a good German idea that had become a bad Hungarian fact." Bankers, especially outside of Budapest, reportedly were ill-informed about available options and were unable to assist entrepreneurs who read about credit programs and came to their banks seeking information. One entrepreneur said that his local bankers, unfamiliar with processing loan applications, had instituted a system in which they delayed action on existing loan applications until they accumulated US$250,000 in requests.

As in Poland and the CSFR, researchers heard numerous complaints about inadequate financial services. Over 60 percent said they were dissatisfied with their banks and that they would switch immediately to a Western bank for their financial services if one were available. Specifically, entrepreneurs complained of excessive transactions time for virtually all transfers of funds, domestic and foreign. Several entrepreneurs cited cumbersome and slow procedures for obtaining foreign currency needed to purchase imports. Other complaints concerned ineffectual loan officers who knew little about appraising private businesses, cared less about assisting them, and sometimes demanded payment for processing their loan applications; the absence of over-draft provisions; and lack of confidentiality.

The Business Environment: Favorable and Unfavorable Aspects

This section cross-cuts a number of issues to briefly characterize several important aspects of the business environment faced by Hungarian producers in September 1991. Section 1 highlights several factors that appeared to work mostly in favor of private producers including: labor markets, infrastructure, real estate markets, and social and political attitudes. Section 2 supplements the section above on major constraints and focuses on three aspects of the business setting that seemed to work mostly against entrepreneurs: weak product markets, several elements of the regulatory framework, and the informal network of personal connections. The relationship between private firms and the dominant state sector is examined within each of these topics.

Favorable Aspects

(i) Labor markets and labor culture. Labor markets in Hungary appeared to function fairly well. Unlike in Poland and CSFR where the illusion that state employment is secure employment persisted at the time of those surveys, the balance in Hungary seemed to have shifted such that most people believed that private sector jobs offered greater security and opportunity than jobs in the disintegrating state sector. Open competition for desirable workers prevailed. Whether due to greater
flexibility in the housing market or to the smaller size of the country, mobility of the Hungarian work force appeared less problematic than in Poland where available housing was almost entirely predictive of the pool of available employees.

Many entrepreneurs complained that their workers' skills were too narrow for their needs, but most considered their work force productive and motivated. In addition to rising salaries, several factors may account for the reportedly high motivation of Hungarian workers. First, many Hungarians managers and employees worked previously in pre-1989 enterprises (excluding state firms) where productivity was linked to financial returns. Second, the growing unemployment rate in Hungary had created anxiety in the work force, motivating many to maximize the security of their present jobs. Third, unlike their Polish counterparts who were stymied in the face of unproductive workers, most Hungarian employers were quick to take action by laying off undesirable workers and establishing acceptable norms.

(ii) Real estate markets. However imperfectly, real estate markets in Hungary were functioning sufficiently well that 90 percent of entrepreneurs agreed that factory space was available for lease almost everywhere, although prices were rising with demand. Half thought it was affordable, and half considered available space too expensive. Prices around Budapest clearly were higher than elsewhere, and entrepreneurs in Budapest had more often split their production into several locations because they were unable to find one space large enough for their whole operation.

The critical problem in real estate markets was sale of state-owned property, held up by the privatization program. Researchers interviewed many entrepreneurs who were stuck in holding patterns of leasing space that they were ready to purchase while they waited for the State Property Office to approve the sale. Leasing had the advantages of offering space to cash-poor entrepreneurs, especially in the cases of lease/purchase agreements. But delays for those who were ready to buy had postponed needed renovations and rendered financial planning difficult as entrepreneurs could not be sure that the price agreed upon would be the real price when the sale was finalized. The inability to close property sales also handicapped entrepreneurs when they applied for loans without property for use as collateral. In general, entrepreneurs mistrusted officials at the State Property Office, suspecting them of accepting bribes to move sales up on the waiting list and to fix prices.

(iii) Infrastructure. It can not be said that existing infrastructure in Hungary had fostered the development of private sector manufacturing, but it can be said that Hungarian infrastructure appeared less problematic than elsewhere in Eastern Europe. Telephone services were poor, but most people had their own lines and some had purchased cellular telephones for more reliable service. Unlike in Poland where some entrepreneurs were putting in service roads, plumbing and their own power sources, almost all Hungarian entrepreneurs were able to rely on existing infrastructure. Renovation of buildings consisted mainly of partitioning large previously state-owned enterprises into smaller factories. A typical situation was one where a cavernous state enterprise had been partitioned into 20 or 30 limited liability companies.

(iv) Attitudes toward private enterprise. Hungarian entrepreneurs differed somewhat from their counterparts in Poland and CSFR by rating government officials' attitudes toward private enterprise as relatively more negative, and by rating the attitudes of managers of state enterprises relatively more

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30/ Some state enterprises reportedly were receiving low-interest banks loans to pay 80 percent of salaries to thousands of laid-off employees, a practice that incensed entrepreneurs who felt that such policies undercut workers' motivation to accept and keep new jobs.
positively. Specifically, 66 percent of respondents said that attitudes among government officials were negative with only 34 percent giving a neutral or positive rating. In contrast, 58 percent said that managers in state firms viewed them neutrally or positively, 42 percent negatively. Similarly to Polish and Czech and Slovak entrepreneurs, half of Hungarians said that private citizens had a negative attitude toward them, and half said social attitudes were neutral or positive.

Differences in attitudes among Hungarian entrepreneurs probably are attributable to the history of private enterprise in Hungary. For years, the government was an adversary as Hungarian entrepreneurs pushed the limits of regulations affecting private enterprise. This adversarial relationship has continued as entrepreneurs constantly seek avenues to evade government regulations they view as unfair. In contrast, relationships between managers of state enterprises and many private entrepreneurs often were ones of cooperation, far more so than observed in Poland and CSFR. As described throughout this report, many private enterprises in Hungary grew out of state enterprises, and the level of interdependence between state and private sectors was high.

Unfavorable Aspects

(i) Input and output markets. Product markets in Hungary were weaker than expected, particularly in comparison to Poland. On the input side, 41 percent of entrepreneurs said that they had problems obtaining the raw materials and intermediate inputs they needed. Entrepreneurs who relied on state enterprises for their raw materials might well have obtained cheaper prices relative to imported substitutes, but they also faced a number of problems. First, some state suppliers were in the process of privatization/restructuring and their production was unstable, making them unreliable as suppliers and forcing entrepreneurs to tie up scarce working capital in large inventories. Second, the historical structure of production in the state sector appeared ill-suited for the needs of private producers for small volume and quick delivery. Entrepreneurs reported that many state suppliers had instituted minimum order sizes, and that orders had to be placed far in advance of delivery time. Third, private enterprises typically competed best with highly differentiated products that required specialized inputs normally not available from large state companies that typically produce uniform goods with reportedly little feel for the market.

Entrepreneurs who used imported inputs obtained them from two principle sources: foreign partners in subcontracting arrangements and state trading companies. The notable absence of private import/export traders reflected weak development of retail markets in Hungary which was, in part, due to slow privatization of the retail sector and, in part, due to restrictions on access to foreign exchange for individual traders. Entrepreneurs had many complaints about state trading companies as suppliers of imported inputs. They reportedly are large companies whose main customers are state enterprises that place large orders. Again, entrepreneurs were unable to secure the small amounts of specialized inputs they needed, and orders had to be placed far in advance. They complained that trading companies, with

31/ To recall figures from Chapter IV, the state sector accounted for three quarters of inputs purchased by sample entrepreneurs (in value terms) and the private sector, one quarter. Thirty percent was imported.

32/ The few entrepreneurs who used large quantities of imports purchased them directly from foreign suppliers, but the quantities used by most sample firms were too small to purchase directly. Direct purchases also were discouraged by cumbersome procedures related to obtaining foreign exchange.
little feel for the market, did not stock the kinds of inputs critical to manufacture competitive products. Typical was the small manufacturer of high quality children's clothing who complained that he was unable to locate supplies of the same fabric more than once and that he had to scour the country to get the accessories he needed.

On the output side, some entrepreneurs had problems locating sufficient outlets for their products because of a poorly-developed, fairly non-competitive retail sector. Many entrepreneurs, particularly smaller firms, relied on state trading companies to distribute their goods. These entrepreneurs complained that the trading companies increasingly refused to buy from them as they were overstocked from state enterprises anxious to off-load goods and from imports upon which they hoped to make high profits. One drug manufacturer was forced to rely on state-owned distributors because he could not locate a sufficient number of retailers to absorb his production. Those who tried to sell directly to retailers found that many had contracts to purchase their merchandise from state distributors and would not buy directly from them. For example, one small soy oil producer tried to market his oil to retail stores only to find that they were locked into state-owned distribution centers. In sum, market entry in Hungary appeared to depend not just on producing a superior product at a lower price, but also on identifying or developing appropriate retail outlets.

(ii) The Policy and Regulatory Environment. The success of the Hungarian government in liberalizing the laws and policies that affected private enterprise was evident in the large numbers of new entrants, but problems remained. Three presented discernable problems for significant numbers of entrepreneurs: (a) the number of licenses and permits required and the time and effort required to obtain them; (b) high tax rates; and (c) slow implementation of privatization policies.

(a) Unlike in Poland where few entrepreneurs complained of problems obtaining needed licenses and permits, a third of Hungarian entrepreneurs said that they had problems. No single regulation presented ongoing, significant difficulties for entrepreneurs, but the cumulative effect of compliance with many regulations appeared costly and time-consuming. Seventy-five percent said that it took them more than a month to get required permits, and half said that it took more than three months.

Initial registration as a limited liability company took a relatively short time, though many thought the requirement of one million forints for start-up capital was excessive. Environmental regulations frequently were cited for lack of clarity as to their content and poor implementation on the part of government officials. Examples include a PVC producer who had heard that PVC could no longer be used with food products; a producer of water purification equipment who reported falling demand due to lax implementation of waste treatment regulations in state enterprises, his primary clients; and a third entrepreneur whose permit for waste processing was held up for six months because ministry officials did not know how to process his paperwork. The requirement that attorneys witness a great number of documents appeared to raise costs for many entrepreneurs unnecessarily. For example, one man complained that a simple three-page contract costs him 70,000 forints in attorney's fees. The necessity of paying bribes to get through official red tape was reportedly pervasive.

(b) As in Poland and CSFR, Hungarian entrepreneurs were heavily taxed. Entrepreneurs were charged 40 percent on their profits; 43 percent social security tax on their workers plus 1.5 percent for a national unemployment fund; turnover taxes of up to 25 percent; and income tax rates of almost 50 percent on incomes of 150,000 forints (increasing to a maximum of 50 percent plus 146,600 forints). Although many entrepreneurs had found means of avoiding full payment of taxes, most still had high taxes bills and many also paid the price of doctored profits when they applied for loans.
(c) As stated above, privatization of state-owned enterprises was progressing very slowly in Hungary in September 1991. In some ways, the impact of stalled privatization on private Hungarian firms appeared less negative than observed in Poland where assets in state enterprises essentially were locked up until privatization. In Hungary, private entrepreneurs had extensive access to state-owned assets through leasing arrangements. But hastening privatization will hasten adjustment among private intermediate goods producers who depend on the state sector as their main customers. Delaying privatization maintains distorted signals in the market place and forestalls needed restructuring in the private sector. The net result is that declining state enterprises slowly pull their suppliers down with them. In addition, the failure to privatize the small-scale sector, particularly the retail sector, has impeded the development of product markets and limited private producers' choices of suppliers and buyers.

(iii) The informal networks. Almost all entrepreneurs described an extensive and strong informal network of personal connections that reportedly operated in most markets. That such a network was so well developed in Hungary is not surprising given that the large second economy depended largely on personal relationships for its survival. For some, its continued existence was highly advantageous. Exploitation of that network enabled many former GMKs, small cooperatives, and industrial divisions of agricultural cooperatives included in this sample to maintain and expand their production in the new economy. But for many newcomers, it was a barrier. Many of these entrepreneurs reported problems in their interactions with suppliers and buyers because they were without needed connections and because markets remained highly imperfect. At the time of this survey, informal networks clearly were stronger than formal channels. Over time, one would expect the balance to shift.

Prospects: Strong Firms vs. Weak Firms

Groups of strong and weak firms were identified and compared with one another to help clarify factors associated with success. Firms were classified according to three criteria:

(i) whether production had increased in the previous months;
(ii) whether profits had increased in the previous months;
(iii) rankings given each firm by interview teams.

Survey teams ranked firms' prospects based on having listened to their owners and managers, viewed their facilities, examined the trends in their businesses, and applied knowledge from other firms in the same sectors. Prospects were considered positive for 46 percent of firms, unclear for 39 percent, and poor for 14 percent. A positive ranking was given to firms managed by apparently competent entrepreneurs who were manufacturing products for which demand was growing or relatively inelastic, and for which serious import competition was unlikely. Unclear prospects meant that the entrepreneur appeared competent, but prospects depended on conditions in the general economy, the appearance of competing imports, and events in the state sector. Poor prospects meant that survey teams predicted that these firms would fold barring significant changes.

Firms were classified as strong if all parameters were positive: production was increasing, profits were rising, and interview team ratings were positive. Weak firms were those for which all

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33/ As reported in Chapter IV, 40 percent of entrepreneurs said that production had increased in the previous three months, 21 percent said it had remained the same, and 36 percent that it had decreased. Similarly, 61 percent of entrepreneurs said that profits had risen in the same period, 7 percent that profits were unchanged, and 32 percent that they had declined.
parameters were negative: production had decreased, profits were falling, and ratings were poor. The relative strength of sample firms in Hungary is shown by the fact that 27 firms were classified as strong firms, and only 12 as weak. The remaining 67 firms fell in between, ranking positively on some criteria and negatively on others.

Strong and weak firms diverged along many dimensions. Starting with basic characteristics, strong firms were larger than weak ones: 65 percent had more than 20 workers compared with 41 percent of weak firms. A third of strong firms manufactured machinery; weak firms were concentrated in plastics (33%) and metal-working (25%). Strong firms were distributed among new firms and pre-1989 firms in proportion to their representation in the sample, i.e., 75 percent were pre-1989 firms and 25 percent were new start-ups. The weakest new firms tended to be headed by inexperienced entrepreneurs and to rely on sub-contracting from a foreign partner. The weakest pre-1989 firms were going down with their state customers. Both strong and weak firms were located in cities, towns, and villages proportionately to the sample as a whole.

Not surprisingly, production equipment in weak firms was older, worth less, and more likely to have been manufactured domestically. The average replacement value of capital stock in strong firms was US$408,400 compared with US$80,700 in weak firms. The value-weighted, average age of equipment in strong firms was 8.1 years compared with an average of 12.8 in weak firms. Domestic equipment accounted for 62 percent of the value of production equipment in weak firms, as compared with 39 percent in strong firms.

Both strong and weak firms bought most of their inputs from state enterprises, but output markets differed. State enterprises were the main customers for only 34 percent of strong firms as compared with 73 percent of weak firms. As noted, dependence on state-owned customers brought problems with declining orders and delinquent payments—problems that strong firms were avoiding by searching out other markets. Almost a third of strong firms sold to a mix of customers from their own factories, but none of the weak firms sold in this fashion. Surprisingly, only 19 percent of both strong and weak firms exported. Anecdotal evidence suggests that the weak exporters were subcontractors for foreign firms, and the strong exporters were selling directly to foreign buyers.

Strong and weak firms had different competitors. Strong firms competed mainly with state enterprises, the least formidable competitors. Only 8 percent listed imports as their major competitors. Weak firms competed equally with state enterprises, other private firms and imports. As seen in Poland and CSFR, strong firms faced far fewer competitors than weak firms: 72 percent of strong firms reported fewer than 10 competitors compared with only 27 percent of weak firms.

In sum, the keys to success among private manufacturers in Hungary in September 1991 were strong personal connections usually based on past linkages, a good product, use of middle-aged (not ancient) equipment, and careful cultivation of niche markets (domestic or foreign) that avoided reliance on the state sector and skirted competition. Similarly, the keys to failure were lack of experience, use of very old production equipment, production of an undifferentiated good that faced many competitors (due to low entry costs), and reliance on state enterprises as major customers.
VI. NEEDS FOR ASSISTANCE AND RECOMMENDATIONS FOR ACTION

Section A of this chapter summarizes the types of assistance requested by entrepreneurs. Section B reviews entrepreneurs’ perceptions of current assistance programs. Section C contains a series of recommendations for action, based on the constraints cited in Chapter 5 and the more specific requests for assistance described here.

Requests for Assistance

Most Hungarian entrepreneurs requested the same types of assistance as their counterparts in Poland and CSFR, namely: management, marketing, consultation on technology, and language training. As in Poland and CSFR, requests for help with improving management reflected entrepreneurs’ desire to improve their businesses and their belief that they could be operating better than they were. "Management" included all areas of operating a business from organizing production to motivating the labor force to financial planning.

Although one in four entrepreneurs requested assistance with management, points of departure varied greatly depending on whether entrepreneurs were experienced or relative newcomers. Researchers found that most experienced entrepreneurs were consummate managers with navigation skills perfectly adapted to Hungary’s highly imperfect business environment. These entrepreneurs were expanding rapidly with little capital, building their businesses through their connections, wits and ambitions. Future plans were well-developed with similar objectives: diversification into related, higher quality products, acquisition of more property, and elimination of middlemen. Examples include garment makers who wanted to make their own inputs instead of getting them from foreign partners, pastry-makers who wanted to sell their goods directly from their own shop instead of working as wholesalers, and window and door makers who wanted to move into furniture production. As one of experienced manager said, "We are like swimmers who trained for years with weights. Now the weights have been removed, and we are well-prepared for the race".

Newcomers were another story. Like new entrepreneurs in Poland and CSFR, many were floundering without knowledge of basic business practices. They were learning by doing. Many new start-ups were "outsiders" without access to the many informal channels seemingly necessary to operate a successful manufacturing business in Hungary. Their lack of knowledge about the optimal way of organizing their businesses compounded the difficulties they faced in accessing markets. As in Poland, new start-ups in Hungary had to devote their full attention to meeting current production needs with little time or confidence for business planning.

Entrepreneurs differed in their abilities to market their products, but many could have used assistance. The more experienced managers knew how to extract the maximum from the system, but the system itself was in flux and those who depended on a few large contracts from one or more state enterprises were in trouble. These entrepreneurs were well aware that their former niches had all but vanished with the downturn of the state sector, and that their survival depended on their ability to re-orient their production and enter new markets. Some were stymied, particularly those in rural locations. Some small enterprises with 10-20 workers--particularly former craftsmen and new start-ups--were perplexed about how to broaden their markets. These entrepreneurs typically were too large to rely only on local niches, but felt that they could not afford to conduct their own market research. As a consequence, most small firms that sold beyond local markets relied on state distributors and trading companies, shrinking their profits in the process.
Other entrepreneurs were marketing their products successfully, mostly by selling directly and avoiding marketing cooperatives and state trading companies. Researchers encountered none of the aversion to public advertising seen among Polish entrepreneurs. Indeed, many Hungarians were aggressively using local media of all kinds, and quite a number had conducted their own market research or had found a supplier of market information. One man making plastic hospital bags had greatly increased orders from former days as a cooperative by direct marketing. He had mapped out all the hospitals in the country and organized sales campaigns by mail and telephone, selectively using a private marketing firm to write ads. Another had used the services of the Budapest Chamber of Commerce to target foreign markets for promotion.

In foreign markets, almost half of exporters were selling directly to foreign buyers based on aggressive marketing strategies. Entrepreneurs described frequent trips to Western countries, particularly to Germany, to locate new buyers as well as foreign partners. All avenues were exploited from family connections to advertisements in trade journals. The Hungarian government’s emphasis on exports to the West in the 1980s brought long-term gains as entrepreneurs who worked previously in exporting state enterprises and cooperatives built on those early contacts to forge larger, new partnerships.

The imperative of competing in Western markets also brought an acute recognition of the importance of upgrading technology, a process considered synonymous with acquiring modern equipment. Exporters, in particular, knew that their competitive edge stemmed from low labor costs, and many were anxious to increase profits by upgrading product quality and increasing efficiency. The need for more efficient equipment often was obvious as entrepreneurs struggled to fill large, mostly foreign orders in short time periods. Entrepreneurs with the greatest exposure to the West knew what was needed and even which machines would make the difference, but they lacked the capital. Others were unsure of how to increase the competitiveness of their products, and they requested assistance in sorting through their options and choosing the best technologies for their needs.

Many entrepreneurs requested language training in German and English. Most Hungarians were not reticent in seeking out foreign trading partners, but they believed that they would be more effective if they could communicate directly in Western languages. Some felt forced to rely on trading companies to handle their foreign trade because they felt inadequate to negotiate themselves for lack of German or English. In addition, many had acquired trade journals most of which were in English.

Entrepreneurs’ Views of Existing Assistance Programs

Existing Assistance Programs

Over 80 percent of entrepreneurs had heard about special programs to assist private business, and an estimated 20 percent had participated in some way. Evaluations by those who had participated were mostly positive. Courses noted as helpful included: a tax course offered by the government, a course offered by an American group entitled “Women as Entrepreneurs”, a course offered through Oxford University Business School, courses in finance offered by the Finance Ministry, MBA courses offered by a local business school, and a seminar offered by the SEED Foundation. Services that had proved useful to entrepreneurs included those offered by the Hungarian Association of Entrepreneurs and the Budapest Chamber of Commerce.

Entrepreneurs had somewhat paradoxical attitudes toward technical assistance programs. On the one hand, a large majority said that assistance programs were best offered by private, for-profit companies and next best by foreign assistance organizations. But on the other hand, entrepreneurs were
full of complaints about the numbers of new private companies trying to market their services. Some entrepreneurs claimed that they daily received notices of courses and letters from new consulting companies. Entrepreneurs thought fees were exorbitant, and most expressed doubts that these consultants had useful information to offer. As one entrepreneur said, "It's typical of Hungarians that they want to make money out of nothing".

Entrepreneurship Associations

Almost half of entrepreneurs were members of the Hungarian Association of Entrepreneurs, compared with 23 percent of Polish entrepreneurs and 25 percent of Czechs and Slovaks who were members of any membership association. The Hungarian Association has been operating for over a decade and, by all accounts, has been highly effective in representing private sector entrepreneurs' interests at the national level as well as serving as a comprehensive clearing house for all kinds of information needed by private producers. Most entrepreneurs who were members expressed satisfaction with the services they had received from the Association in exchange for their dues. The success of the Hungarian Association in representing a national, highly varied constituency stands in sharp contrast to the situation in Poland, where a plethora of associations claim to represent entrepreneurs' interests, and in CSFR where the leading Czech Association has become a political party that reportedly has lost touch with entrepreneurs, particularly those in the countryside.

The Government as a Source of Assistance

Entrepreneurs were quick to respond when asked what they thought the government should do to support private sector development, and their responses reflected a healthy self-interest. The most common recommendations were the following:

(i) Loan terms should be longer so that entrepreneurs are better able to purchase state-owned property. New firms should be granted a two-year grace period on interest for loans used to purchase start-up equipment. Lower interest rates should be offered for purchasing Western equipment, but high rates should be maintained for loans used to purchase Western goods. The government should step in and lower collateral requirements for loans for small and medium firms.

(ii) New private firms should be granted tax holidays for the first two years. Increased tax breaks should be granted for earnings that are invested. Import taxes should be raised to further protect Hungarian producers, and illegal imports should be better controlled.

(iii) The government should cut off all assistance to state enterprises and should prosecute corrupt state managers. Entrepreneurs who survive for two years should be allowed to purchase state assets at favorable rates.

Recommendations for Action

Improvement in a few large, critical areas could have enormous impact on private sector manufacturers. The following recommendations were formulated and prioritized based on entrepreneurs' accounts of their constraints, researchers' judgements based on hundreds of hours observing Hungarians and their firms, and a preliminary assessment of the strengths and weaknesses of Hungarian firms relative to firms surveyed in Poland and CSFR.
The most important recommendations are the following: (i) increase the flow of institutional credit to private sector manufacturers; (ii) expedite privatization; (iii) improve the efficiency and the scope of financial services; (iv) increase the flow of needed information; and (v) reduce red tape.

(i) Unlike the common situation where entrepreneurs' complaints about lack of access to credit camouflage deeper problems, the credit crunch in Hungary was a pivotal problem for most entrepreneurs. Many were ready and able to expand but were blocked by shortages of investment capital needed to purchase or expand factory buildings and to modernize their production equipment. Where production was geared to the state sector, particularly in pre-1989 firms, entrepreneurs were anxious to restructure but lacked the capital to do so. The effect of highly imperfect input markets was exacerbated by the absence of bridge financing that would smooth production.

Improved access to credit for private producers would appear to require action on several fronts. First, provision of credit to the private sector must be given high priority within the banking sector. Second, loan requirements should be assessed for their reasonableness. Banks should require adequate security from loan recipients, but restricting security only to factory buildings and land seemed excessive given the limited opportunities for acquiring industrial property. Third, entrepreneurs in good standing should have greater access to short-term financing to cover the costs of raw materials and fourth, banks should incorporate effective means of collecting arrears from the outset.

(ii) Using whatever means feasible, privatization should be expedited so that assets can flow from state to private hands as quickly as possible. First, the dominant presence of many large state enterprises maintains distortions in the economy and impedes the formation of markets. The final adjustment to a full market economy is delayed, and entrepreneurs are forced to structure their production around distortions. Second, as emphasized throughout this report, most entrepreneurs interviewed demonstrated their desire and ability to maximize the productivity of assets available to them. It seems safe to assume that they would continue to make productive use of privatized assets. Third, privatization will catalyze needed restructuring among private suppliers of state firms. As discussed above, entrepreneurs reporting softening demand for their products relied disproportionately on the state sector and, in the long run, they must either re-direct their production or close down. Fourth, further privatization of distribution and retail sectors should improve product markets through new entrants and more competition. Fifth, privatization will hasten the demise of large informal inter-enterprise credit networks that benefit insiders but block outsiders.

(iii) Entrepreneurs would benefit greatly from improved efficiency in the banking sector. The process of applying for loans should be simplified and made more transparent. Loan officers' skills in appraising and processing loan applications should be improved. The time needed for routine financial transactions should be greatly reduced, and foreign transactions made more efficient. Banks should assess the feasibility of offering a wider range of financial services to their customers. Regulations prohibiting full operations by foreign banks in Hungary should be examined with an eye to increasing competition in the banking sector.

(iv) As was the case in Poland, a primary objective of technical assistance for entrepreneurs should be delivery of courses in business basics for new entrants. Such courses should teach entrepreneurs how to carry out feasibility studies and write business plans. Financial planning should figure prominently on course agendas. Short courses on business basics should be offered as frequently and in as many locations as possible, and only minimal fees should be charged.
Beyond the basics, accelerating the flow of more specialized information about new products, technologies and markets would benefit most entrepreneurs interviewed. Because import competition was minimal in many cases, the quest for good information was fed by the desire to further penetrate foreign markets. In keeping with characteristic Hungarian eagerness to know as much as possible as fast as possible, many entrepreneurs had taken the initiative to find the information they needed through visits to the West, trade fairs and written material. But others, particularly those outside of Budapest, were hampered in their efforts to break into new markets by inadequate information about their competitors. A good number of entrepreneurs were faced with the need to re-orient their operations away from the state sector and towards domestic and export markets and yet, few had the information needed to make informed choices. The flow of technical information perhaps could be increased by selective support of well-placed, reputable institutions such as the Association of Entrepreneurs, the Budapest Chamber of Commerce and others that reach beyond Budapest.

(v) Regulations pertaining to private sector operations should be streamlined and better implemented. As discussed above, entrepreneurs were forced to wade through more red tape than necessary, and the number of permits and licenses required could perhaps be reduced or at least consolidated. The process of complying with regulations seemed overly complex, as evidenced by the widespread use of attorneys to complete applications and the pervasive practice of bribing officials to get necessary permits. Specific candidates for improvement are environmental regulations and import procedures. Implementation of existing regulations could be much improved by curtailing the personal discretion of officials, particularly local officials.
VII. CONCLUSIONS

This chapter sums up research findings in the context of some of the research issues posed in Chapter I. Section A looks at linkages between Hungary's unique history and the emerging private manufacturing sector. Section B examines the impact of the content and sequencing of the 1989 reforms on sample firms. Section C comments on relations between sample firms and the state sector, and Section D speculates about the future of private sector manufacturing in Hungary.

What Difference Does History Make?

A series of questions can be asked about the linkages between Hungarian experiments with partial liberalization of private enterprise over the past decade and the emerging of a private productive sector. The first asks whether the Hungarian private manufacturing sector has grown more rapidly as a result of the large, private second economy that developed in the 1980s. The answer clearly is yes.

Substantial private, informal sectors were already in place when private sector entry was liberalized in Hungary and in Poland in 1989. Accounting for about a third of total employment and of GDP in 1991 in Hungary and about 25 percent of total employment and approximately 20-30 percent of GDP in 1991 in Poland, the private sectors in these countries have expanded their original base to take major roles in their economies quickly. Indeed, 66 of the 106 firms in the Hungarian sample came from transformation of second economy enterprises into first. Such was not the case in CSFR where private enterprise was minimal prior to 1990. Despite rapid growth and dynamic entrepreneurship among the Czechs and Slovaks, the private sector share of employment and GDP had only reached about 16 and 8 percent, respectively, by end-1991. Without question, starting with a substantial base of private activity has meant that private sectors can more quickly assume a larger portion of total activity than when the starting point is a small base.

A second question is whether performance and prospects differed for pre-1989 firms and new start-ups? Survey results indicated substantial differences. Without question, privatized pre-1989 enterprises (including craftsmen, state firms, enterprise work partnerships, small cooperatives, and industrial divisions of agricultural cooperatives) were the powerhouse of the sample. To recap, pre-1989 companies accounted for 75 percent of sample firms, 89 percent of total sample sales, and 87 percent of exports. The 27 new firms in the sample were smaller as a group, accounting for only 11 percent of sales and 13 percent of exports.

Prospects for each group were less clear. The advantages and disadvantages held by pre-1989 enterprises and new entrants appeared about equal in weight, but they differed in content. As seen in CSFR where large numbers of sample firms had origins in the state sector, pre-1989 firms in Hungary faced substantial needs for restructuring. Their former customers, state enterprises, were declining and demand for their products typically was weak. Reorientation typically involved shifts in product lines, upgrading product quality, and increasing efficiency. The most dynamic were well on the way to making these changes, and many had established strong export links. Others were stymied by inflexible production equipment, lack of access to finance, and inherited labor forces that were inappropriate in size and skills. Important advantages held by these firms included the considerable skills of most of their managers, sweet deals on buildings and equipment, and membership in the large network of personal connections among suppliers and customers that prevailed in Hungary.

New start-ups (by experienced and inexperienced entrepreneurs) held the considerable advantage of having chosen their products, their mix of capital and labor, and their technologies after price
liberalization when price signals were relatively undistorted. Therefore, they were spared restructuring costs and their resources could be used to purchase facilities and new equipment. Managers of new start-ups were of two types: highly skilled entrepreneurs (mostly engineers who worked previously in quasi-private enterprises) who were exploiting export markets with great success, and less savvy individuals without strong technical knowhow who were struggling to develop new, small companies without benefit of basic business skills.

The final question asks whether entrepreneurs who had previous experience managing private or quasi-private business had better chances for success in the present? Survey results indicated that experience made a big difference. To recap, entrepreneurs who managed private or quasi-private businesses before 1989 represented 50 percent of entrepreneurs surveyed but nearly 80 percent of total sample sales and exports.

An interesting question that flows from this analysis asks why pre-1989 entrepreneurs in Hungary were strong performers when pre-reform entrepreneurs in comparable surveys in Poland and CSFR were among the poorest performers in those samples. The answer is that pre-reform entrepreneurs were not the same people across the three countries. In Hungary, the industrial entrepreneurs of the 1980s included both traditional "craftsmen" and managers and members of economic working partnerships (VGMKs, GMKs) and small and agricultural cooperatives. Hungarian "craftsmen" captured in this survey were substantially larger than their Polish and Czech and Slovak counterparts--average full-time employment was 48 workers and average monthly sales were $83,000. But they faced many of the same problems with skills that were too narrow and markets that were too tightly bound to the state sector.

Entrepreneurs who traced their origins to the economic work partnerships and small cooperatives were quite a different story. It must be remembered that the membership of these pre-1989 enterprise forms consisted of the most highly technically skilled workers in the Hungarian state enterprises. It was not surprising, therefore, to find that most had strong technical skills, were accustomed to organizing production, and had good notions of how to operate a private business. The foundation for their skills was a decade of exposure to many of the critical elements of private enterprise: competition, marketing, and profits as a function of productivity. In addition, they entered fully private enterprise post-1989 with the strong personal connections needed to access production equipment, stable inputs and the best markets.

In sum, Hungary's experiments in the 1980s with improving the performance of the state sector through allowing quasi-private enterprises to serve as back-up producers may have failed in their stated goals, but the dividends have been great as realized in a cadre of strong industrial producers who now operate as the backbone of the new, private industrial sector. This group of entrepreneurs faces tremendous challenges as their traditional markets in the state sector dry up, but researchers' observations were that many had sufficient skills and savvy to re-orient their businesses to take advantage of new opportunities.

The Impact of the Reform Program

Without question, the manufacturing firms surveyed in this project had benefitted enormously from the reforms of 1989 and 1990. Legal and regulatory reforms had cleared the way for massive entry, and liberalized prices provided the framework within which they would operate. The currently large contribution of the private sector to the economy is powerful testament to the success of the reforms in facilitating private sector growth. The government's unambiguous welcome to foreign investors also has produced remarkable results.
Survey results indicated that three policy areas warrant examination: privatization, foreign exchange policies, and financial sector reform.

**Privatization**

Despite a spate of approaches, few large state industrial enterprises were privatized, and privatization of the small-scale sector—including the retail sector—was far from complete in September 1991. Failure to bring about effective privatization of the state sector obviously influenced the entire domestic business environment faced by private producers, but in one aspect, the effect was particularly negative. Many state firms that were primary customers for sample entrepreneurs were suffering decline and imminent bankruptcy. Entrepreneurs who had not established strong export markets were vulnerable to going down with their state customers. The Hungarian economy probably will remain a mixed one, with continuing state ownership for the foreseeable future. But postponement of privatization in those firms that will be transferred postpones the final adjustment for the many private producers who rely on state customers. Their chances for survival would be heightened by speedy privatization which would enable them to evaluate the new signals and re-orient their businesses as needed. At the time of the survey, many appeared to be slowly sinking with their state customers without clear signals that would guide their decisions.

Of note is the fact that difficulties in accessing production equipment and physical space owned by the state—a big problem in Poland—were mitigated for many Hungarians through leasing arrangements. To the extent that widespread leasing of state assets allowed entrepreneurs to start up businesses without large capital outlays, delays in privatization may have benefited some entrepreneurs in the short run. But in the longer run, entrepreneurs will need to build a capital base, and there is little question but that most state-owned assets would be used most productively by private agents.

In part due to incomplete privatization of the small-scale, particularly the retail sector, product markets in Hungary were weaker than anticipated. As documented above, many entrepreneurs reported problems securing the inputs they needed in the quantities, qualities and time frames they needed. They also suffered from having a relatively narrow range of options for selling their products outside of the state sector. A seemingly high proportion of domestic trade still flowed through state trading companies which reportedly were not well-suited to the needs of small producers. The contrast to Poland where near-complete small privatization contributed to the formation of a vibrant, competitive retail sector was obvious. Rapid, full privatization of Hungary’s small-scale sector would contribute to improvement of product markets.

**Foreign exchange policies**

Without question, lack of access to foreign exchange for individual traders at levels needed to import goods for re-sale on a reasonable scale had limited the inflow of imports and also contributed to weak development of retail markets. On a broad scale, the impact of this policy was mixed, and the implications unclear. On the one hand, limiting the inflow of imports through limiting the range of agents who could bring them in meant that competition, especially from imports, was moderate at the time of the survey. Protection from imports afforded entrepreneurs time to build their businesses before they were subjected to full competition on world markets. All evidence was that most were using this grace period productively. But on the other hand, limiting participation of individual traders relegated most foreign trade to large, mostly state-owned trading companies interested in high-volume sales to state firms. Hungarian entrepreneurs, therefore, did not have nearly the range of choices for suppliers and customers as their Polish counterparts. An interesting hypothesis is that the basis of development of
strong retail sectors in non-shortage transition economies with small domestic markets is ready access to foreign exchange. Certainly the large Polish retail sector was based on sales of imports, and retail sectors in both Hungary and CSFR, where access to foreign exchange has been restricted, have grown far more slowly.

Financial Sector Reform

The banking sector was not meeting the needs of the majority of Hungarian entrepreneurs. Researchers observed many firms that appeared fully capable of expansion but were stymied for lack of credit. The existence of numerous special programs with varying interest rates had created tremendous ill-will among the majority who had not benefitted from lower rates. Also, financial services appeared especially poor with very slow transaction time and unnecessarily cumbersome procedures for foreign transactions. Entrepreneurs spoke eagerly about the possibility of transferring their business to foreign banks, but none were available for routine services.

These findings might justify an inquiry into banking practices for the private sector. Such an inquiry might look into the percentage of credit that is directed to private companies, banks' policies for lending to private entrepreneurs, requirements for speed of transactions, and current procedures for transfers of foreign currency. As elsewhere in Eastern Europe, the question arises as to how private businesses should be appraised and what requirements for security should be in place. Without question, collateral should be required but, given an economy where ownership of private assets was curtailed, perhaps cash flow, business plans, and in-hand orders also should be taken into account. The level of competition within the Hungarian banking sector is another issue worthy of examination.

The Relationship with the State Sector

The private sector in Hungary appeared to be surprisingly well-integrated with the state sector, a state of affairs that bodes well for an integrated, mixed ownership economy in the future. The relatively benign relationship between private and state managers was in contrast to the situation in Poland where most sample entrepreneurs characterized themselves as marginal players on the fringe of the large state sector, and in CSFR where the relationship typically was acrimonious. Relations in Hungary had a number of aspects. First, many entrepreneurs had personal relationships with managers in state firms, and their spirit was not one of competitiveness but one that sought mutual advantage. Second, managers in some state firms allowed some entrepreneurs to participate in inter-enterprise credit networks that, in effect, extended suppliers' credits. The majority of entrepreneurs leased their equipment and buildings from state firms. In these ways, an inter-dependence was created. Third, researchers heard no reports of prejudice against private entrepreneurs or of refusals to sell to them as was the case in CSFR. Managers in state firms were well-acclimated to working with private entrepreneurs when they were operating economic work partnerships inside of state firms, and their experience likely reduced their prejudice. Interestingly, most private entrepreneurs held the government responsible for slow privatization, in contrast to claims heard in CSFR that managers of state firms were trying to sabotage the privatization process.

At the same time, the high level of cooperation between many entrepreneurs and the state sector took place within and maintained a dense network of personal connections among industrialists, a network that had created barriers for some newcomers. Almost all entrepreneurs described an extensive and strong informal network of personal connections in state and pre-1989 enterprises that reportedly operated in most markets. Informal quasi-legal and illegal private enterprise was pervasive in Hungary for years, even preceding the 1982 reforms. Lines between permissible and prohibited activity were blurred over
time, and many Hungarians depended on informal, private enterprise and after-hours work in economic work partnerships to supplement their salaries as state employees. As a result, the economy increasingly took on a dual nature: employment by the state governed by formal arrangements, and employment in the informal and quasi-private sector governed by informal arrangements. As the state sector began to fragment and splinter in 1989 and 1990, personal connections became even more important as spontaneous privatization became prevalent. At the time of the survey, many newcomers were without those connections, and markets were too weak to guarantee them access to inputs and customers. A key element in the transition to a market economy in Hungary, therefore, may be the shift from informal to formal markets where access to resources does not depend on personal connections.

Prospects for the Future

Prospects for the continued strong development of private sector manufacturing in Hungary appeared mixed at the time of the survey. Many entrepreneurs were prospering, especially those who had established export markets. The exceptions were those who were tightly linked to the state sector which was declining rapidly in September 1991, and those who were entirely new to private business. Privatization would clarify the parameters of the new economy for those who are clinging to sales to the state sector and force them to restructure their businesses along new, competitive lines. New, inexperienced entrants will continue to struggle as they learn to operate their businesses effectively, and technical assistance that provides basic business skills would help them. Over time, increasing imports will increase competition as will the growing numbers of new entrants. Those who produce simple consumer goods where economies of scale pertain may be the most vulnerable to increased competition, but those who rely on export markets should continue to prosper. Loosening of credit for private producers could greatly facilitate private sector growth.
ANNEX I: TABLES
Annex Table 1.1: Selected Economic Indicators: Hungary (1980-1991)

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<td>249.6</td>
<td>280.2</td>
<td>278.9</td>
<td>287.9</td>
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<td>4.1</td>
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<td>Gross Fixed Investment (bil 1981 forint)</td>
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<td>Private</td>
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<td>34.5</td>
<td>35.6</td>
<td>30.8</td>
<td>29.3</td>
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<td>157.4</td>
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<td>177.1</td>
<td>162.3</td>
<td>168.4</td>
<td>143.0</td>
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<td>Consumer Price Index (1976 = 100)</td>
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<td>216.0</td>
<td>227.4</td>
<td>247.0</td>
<td>285.3</td>
<td>333.8</td>
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<td>Real Wages Index (1970 = 100)</td>
<td>122.0</td>
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<tr>
<td>Overall Balance</td>
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<td>-31.6</td>
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<td>0.6</td>
<td>-42.5</td>
<td>13.3</td>
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Source: Data from Hungary’s Ministry of Finance, National Bank, Central Statistical Office, and WB Staff estimates.

g/ Estimated.

Annex Table 1.2: External Indicators: Hungary (1980-1991)

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<td>1,021</td>
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<td>Debt Service (percent of exports)</td>
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<td>214,387</td>
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<td>200,838</td>
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<td>-571</td>
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<td>45.83</td>
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g/ Estimated.
Annex Table 1.3: Enterprises by Legal Form and Sector
(Number of Units, year-end)

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<td>1,241</td>
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<td>308</td>
<td>66</td>
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<td>Small coops h/</td>
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<td>5,562</td>
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Source: Hungarian Central Statistical Office.

g/ Operating similarly to state enterprises.

h/ Operating similarly to private enterprises.

g/ Includes joint stock and limited liability companies, mixed private and state ownership.
Annex Table 1.4: Limited Liability and Joint Stock Companies: Firm Size by Branch in Industry (Year-end)

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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>157</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1990</td>
<td>475</td>
<td>105</td>
<td>47</td>
<td>7</td>
</tr>
<tr>
<td>1991</td>
<td>838</td>
<td>153</td>
<td>67</td>
<td>12</td>
</tr>
</tbody>
</table>
## Annex Table 1.4: Limited Liability and Joint Stock Companies:
Firm Size by Branch in Industry (continued)
(Year-end)

<table>
<thead>
<tr>
<th>Branch</th>
<th>Number of Firms</th>
<th>Number of Employees</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>V. Construction materials</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Glass, ceramics</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>VI. Light industry</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wood and paper</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Paper</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Textiles</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Clothing</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leather goods</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>VII. Food processing</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>VIII. Other industry</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Hungarian Central Statistical Office.
<table>
<thead>
<tr>
<th></th>
<th>Number of Firms</th>
<th>Employment</th>
<th>Average Employment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>186,291</td>
<td>407,810</td>
<td>2.2</td>
</tr>
<tr>
<td>1990</td>
<td>233,984</td>
<td>546,020</td>
<td>2.3</td>
</tr>
<tr>
<td>1991</td>
<td>300,000</td>
<td>620,900</td>
<td>2.1</td>
</tr>
<tr>
<td><strong>Industry</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>52,505</td>
<td>139,663</td>
<td>2.7</td>
</tr>
<tr>
<td>1990</td>
<td>101,313</td>
<td>212,948</td>
<td>2.1</td>
</tr>
<tr>
<td>1991</td>
<td>195,350</td>
<td>316,600</td>
<td>0.7</td>
</tr>
<tr>
<td><strong>Trade</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>44,067</td>
<td>78,210</td>
<td>1.8</td>
</tr>
<tr>
<td>1990</td>
<td>56,736</td>
<td>87,363</td>
<td>1.5</td>
</tr>
<tr>
<td>1991</td>
<td>75,555</td>
<td>146,600</td>
<td>1.9</td>
</tr>
<tr>
<td><strong>Transportation</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>61,148</td>
<td>33,518</td>
<td>0.5</td>
</tr>
<tr>
<td>1990</td>
<td>24,315</td>
<td>54,602</td>
<td>2.2</td>
</tr>
<tr>
<td>1991</td>
<td>–</td>
<td>142,900</td>
<td>–</td>
</tr>
<tr>
<td><strong>Agriculture</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>28,571</td>
<td>117,315</td>
<td>4.1</td>
</tr>
<tr>
<td>1990</td>
<td>40,216</td>
<td>147,245</td>
<td>3.7</td>
</tr>
<tr>
<td>1991</td>
<td>–</td>
<td>114,400</td>
<td>–</td>
</tr>
</tbody>
</table>

Source: Hungarian Central Statistical Office.

* g/ Mostly sole proprietorships but also includes 1982 enterprise forms (GMKs, HTs, PTs).

* h/ Mid-year estimates.

* g/ Includes services except for trade and transportation.

* h/ Figures are approximated by extrapolating from available data, and as reported in other publications (Johnson).
Annex Table 1.6: Joint Ventures in Industry by Branch (1989-1991)  
(Year-end)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Industry</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>482</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>1,526</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>2,566</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Fuel, Energy, Mining</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>5</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Metallurgy</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>29</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>43</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Electromechanical</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>220</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>691</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>1,147</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Chemicals</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>67</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>187</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>335</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Construction Materials</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>27</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>71</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Light Industry</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>112</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>384</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>658</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Food Processing</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>35</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>130</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>253</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Other Industry</strong></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>1989</td>
<td>14</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>31</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>54</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: The Hungarian Central Statistical Office.
Annex Table 1.7: Foreign Partners in Joint Ventures Registered in 1991
(Millions of Forints)

<table>
<thead>
<tr>
<th>No. of Joint Ventures</th>
<th>Value of Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>1,316</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>224</td>
</tr>
<tr>
<td>Germany</td>
<td>1,898</td>
</tr>
<tr>
<td>Switzerland</td>
<td>307</td>
</tr>
<tr>
<td>Austria</td>
<td>1,130</td>
</tr>
<tr>
<td>Japan</td>
<td>12</td>
</tr>
<tr>
<td>Italy</td>
<td>314</td>
</tr>
<tr>
<td>Sweden</td>
<td>90</td>
</tr>
<tr>
<td>Finland</td>
<td>24</td>
</tr>
<tr>
<td>Spain</td>
<td>2</td>
</tr>
<tr>
<td>France</td>
<td>92</td>
</tr>
<tr>
<td>Netherlands</td>
<td>96</td>
</tr>
<tr>
<td>Belgium</td>
<td>38</td>
</tr>
<tr>
<td>Canada</td>
<td>51</td>
</tr>
<tr>
<td>Former Soviet Union</td>
<td>15</td>
</tr>
<tr>
<td>Other</td>
<td>33</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>5,642</strong></td>
</tr>
</tbody>
</table>

Source: Hungarian Central Statistical Office.
## Annex Table 1.8: Joint Ventures Registered in 1991 by Industrial Sectors
(Millions of Forints)

<table>
<thead>
<tr>
<th>Industry</th>
<th>No. of Joint Ventures</th>
<th>Capital in Foreign Currency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry</td>
<td>1,040</td>
<td>35,388.6</td>
</tr>
<tr>
<td>Fuel, energy, mining</td>
<td>2</td>
<td>1.4</td>
</tr>
<tr>
<td>Metallurgy</td>
<td>14</td>
<td>1,233.5</td>
</tr>
<tr>
<td>Electromechanical</td>
<td>456</td>
<td>16,024.2</td>
</tr>
<tr>
<td>Chemicals</td>
<td>148</td>
<td>4,937.8</td>
</tr>
<tr>
<td>Light manufacturing</td>
<td>274</td>
<td>1,886.5</td>
</tr>
<tr>
<td>Food processing</td>
<td>123</td>
<td>11,201.2</td>
</tr>
<tr>
<td>Other</td>
<td>23</td>
<td>104.0</td>
</tr>
<tr>
<td>Construction</td>
<td>441</td>
<td>3,685.2</td>
</tr>
<tr>
<td>Agriculture</td>
<td>82</td>
<td>240.3</td>
</tr>
<tr>
<td>Transport</td>
<td>109</td>
<td>593.1</td>
</tr>
<tr>
<td>Trade</td>
<td>3,171</td>
<td>7,654.8</td>
</tr>
<tr>
<td>Domestic trade</td>
<td>2,019</td>
<td>5,655.2</td>
</tr>
<tr>
<td>Foreign trade</td>
<td>1,152</td>
<td>1,999.6</td>
</tr>
<tr>
<td>Other material goods and services</td>
<td>93</td>
<td>2,272.8</td>
</tr>
<tr>
<td>(including water supply)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Services</td>
<td>706</td>
<td>6,776.6</td>
</tr>
<tr>
<td>Business and personal</td>
<td>420</td>
<td>5,614.9</td>
</tr>
<tr>
<td>Healths, social and cultural</td>
<td>252</td>
<td>1,080.0</td>
</tr>
<tr>
<td>Community</td>
<td>34</td>
<td>81.7</td>
</tr>
</tbody>
</table>

Source: Hungarian Central Statistical Office.

## Annex Table 1.9: Share of Foreign Capital in Joint Ventures

<table>
<thead>
<tr>
<th>Percentage share</th>
<th>Number of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>12/90</td>
</tr>
<tr>
<td>0 - 20</td>
<td>793</td>
</tr>
<tr>
<td>21 - 30</td>
<td>798</td>
</tr>
<tr>
<td>31 - 50</td>
<td>3,279</td>
</tr>
<tr>
<td>51 - 80</td>
<td>433</td>
</tr>
<tr>
<td>81 - 99</td>
<td>146</td>
</tr>
<tr>
<td>100</td>
<td>244</td>
</tr>
<tr>
<td>Total</td>
<td>5,693</td>
</tr>
</tbody>
</table>

Source: Hungarian Central Statistical Office.
ANNEX II: SURVEY QUESTIONNAIRE
September 4, 1991
The World Bank
Industry Development Division

Interviewer: ____________________________
Date of Interview: ______________________

1. Firm ID #: ____________________________
2. City/Town: ____________________________
3. Rating in Production (0, √, +, --) _____
4. Overall Firm Rating (0, √, +, --) _____

INTERVIEWING GUIDE FOR HUNGARIAN PRIVATE FIRMS

I. BASIC INFORMATION

/5. Name of Person Interviewed: ________________________________________________

6. Position of Person Interviewed: 0. Owner 1. Manager
8. Other (Specify) _____________________________________________________________

7. Gender: 1. Male 2. Female
8. Age: _______ years

/9. Name of firm: _____________________________________________________________

/10. Address or location: (Be specific) __________________________________________

11. Month/year of registration in the courts as an Ltd. company: ________________

12. Actual month/year of start-up of this business (in any form):

/13. Origin of firm. Why it was started, when, by whom, with what products? Major differences now vs. when it was started. (let the owner tell his/her own story here.)

/14. How was this business started up?
0. Started business alone
1. Started business with my spouse or other family member
2. Started with a friend, colleague, classmate or other
3. Started with a foreign partner
4. Bought or took over the business from the State
5. Bought the business from a family member
6. Bought the business from a non-family member
7. Inherited the business from a family member
8. Other (Specify) ____________________________________________________________
9. N/A
15. What forms has this company taken since starting up?

<table>
<thead>
<tr>
<th>Form</th>
<th>Dates</th>
</tr>
</thead>
<tbody>
<tr>
<td>0. Only the current one</td>
<td></td>
</tr>
<tr>
<td>1. Craftsman (one man business)</td>
<td></td>
</tr>
<tr>
<td>2. Contract Working Community (VGMK)</td>
<td></td>
</tr>
<tr>
<td>3. Economic Working Community (GMK)</td>
<td></td>
</tr>
<tr>
<td>4. Civil Law Association</td>
<td></td>
</tr>
<tr>
<td>5. Other type of Association</td>
<td></td>
</tr>
<tr>
<td>6. Industrial Part of Agricultural</td>
<td></td>
</tr>
<tr>
<td>Cooperative (ISZSZCS)</td>
<td></td>
</tr>
<tr>
<td>7. Small Cooperative</td>
<td></td>
</tr>
<tr>
<td>8. Unlimited Partnership (BT)</td>
<td></td>
</tr>
<tr>
<td>9. Limited Partnership (KKT)</td>
<td></td>
</tr>
<tr>
<td>10. Ltd./Joint Stock</td>
<td></td>
</tr>
<tr>
<td>11. Other</td>
<td></td>
</tr>
</tbody>
</table>

16. Who owns this company?

<table>
<thead>
<tr>
<th>Ownership Type</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>0. The Government</td>
<td></td>
</tr>
<tr>
<td>1. Other state-owned company or cooperative</td>
<td></td>
</tr>
<tr>
<td>2. The owner being interviewed</td>
<td></td>
</tr>
<tr>
<td>3. Other private partners</td>
<td></td>
</tr>
<tr>
<td>4. Private investors outside Hungary</td>
<td></td>
</tr>
<tr>
<td>5. Workers</td>
<td></td>
</tr>
<tr>
<td>6. Local government</td>
<td></td>
</tr>
<tr>
<td>7. A bank(s)</td>
<td></td>
</tr>
<tr>
<td>8. Other (Specify)</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>100</td>
</tr>
</tbody>
</table>

(note: if 0 or 3 are > 50 percent, the firm is ineligible)

17. What is the ownership history of this company?

<table>
<thead>
<tr>
<th>Ownership History</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>0. Fully privately-owned and independent since start-up</td>
<td></td>
</tr>
<tr>
<td>1. Fully private now but previously fully/partly owned by or legally connected to the State</td>
<td></td>
</tr>
<tr>
<td>2. Private but previously owned by or legally connected to a larger private company</td>
<td></td>
</tr>
<tr>
<td>3. Currently private but legally or commercially connected to a state-owned enterprise</td>
<td></td>
</tr>
<tr>
<td>4. Previously associated with a cooperative</td>
<td></td>
</tr>
<tr>
<td>8. Other (Specify)</td>
<td></td>
</tr>
<tr>
<td>9. N/A</td>
<td></td>
</tr>
</tbody>
</table>

18. Please explain the past and current relationship among owners:

_____________________________________________________________________
_____________________________________________________________________
_____________________________________________________________________
_____________________________________________________________________
_____________________________________________________________________
19. What is the legal form of this company?
   0. Limited liability company
   1. Joint stock company
   8. Other (Specify) ____________________________
   9. N/A

20. Principal product/activity/service: ____________________________

21. Hungarian code ________  22. ISIC Code ______________________

23. Secondary product/activity: ____________________________

24. Hungarian code ________  25. ISIC Code: ______________________

26. What was the actual output of your company in the month of August?

<table>
<thead>
<tr>
<th>Product</th>
<th>Units</th>
<th>Selling Price</th>
<th>Percentage of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>100%</td>
</tr>
</tbody>
</table>

27. What percentage of your revenues come from trade? ____________

28. What percentage of your revenues come from services? ____________

29. How have your sources of revenues changed over the past 12-18 months? ____________________________

What are the three biggest problems affecting your business today?
   [Coder]  Explanation (Write down the responses)

30. [ ] #1 ____________________________
31. [ ] #2 ____________________________
32. [ ] #3 ____________________________

(Interviewer: After respondent gives own answers, follow up if necessary to discover the root problem; write in their answers in the blanks above. Later, find the closest answer in the list at the back of the questionnaire and enter its number beside of 30, 31, 32. Most important problem comes first, etc.)

II. THE ENTREPRENEUR

A. Background

33. What was/is your father’s occupation? ____________________________
34. Who is/was your father's employer?
0. The government/Party
1. Public Sector: State-owned firm or cooperative
2. Private Sector: private company or private self-employed person
8. Other (specify) __________________________
9. N/A

35. What was/is your mother's occupation? __________________________

36. Who is/was your mother's employer?
0. The government/Party
1. Public Sector: State-owned firm or cooperative
2. Private Sector: private company or private self-employed person
8. Other (specify) __________________________
9. N/A

37. Has anyone in your family worked in the private sector?
0. No
1. Yes Who, and what did they do? __________________________

38. What is the highest level of school you completed?
0. None
1. Primary
2. Secondary/Gymnasia
3. Commercial Secondary
4. Technical Secondary
5. Vocational a. commercial b. technical
6. College or university
7. Post-graduate
8. Other (Specify) __________________________
9. N/A

39. Have you received any training abroad?
0. No
1. Yes What kind, when, and where? __________________________

40. What do you think is the major source of the primary skills/knowledge you use to operate this business?
0. University/technical education
1. Experience in previous jobs
2. Manufacturer of equipment
3. Purchaser of final product
4. Trade/technical journals
5. Learning on your own
6. Training programs outside of the education system
8. Other (Specify) __________________________
9. N/A

41. What kind of short term training course would be most useful to you today? (circle only the most important one)
0. None
1. Accounting or bookkeeping skills
2. Marketing
3. Skills to obtain financial services from a bank
4. More familiarity with different technologies
5. Legal
6. Management (What kind of management?) __________________________
7. Import/export
8. Other (specify) __________________________
9. N/A
42. In your opinion, what would be the best source of the training you need?
   0. A government program
   1. A foreign assistance organization
   2. A private trade association
   3. A private for-profit company
   4. Local colleges/universities
   8. Other (Specify) ____________________________
   9. N/A

43. How many other private businesses have you owned (fully or in part)?
   0. None
   1. One
   2. Two
   3. Three
   4. More than three
   8. Other (Specify) ____________________________
   9. N/A

44. Who did you work for before you started this business? (For most of your career)
   0. Worked for a government institution. Which one? __________________
   1. Worked for a state-owned enterprise. Which one? __________________
   2. Worked for another private company. Which one? __________________
   3. Worked in another business I owned. What kind? __________________
   4. Worked for a foreign company in Hungary. Which one? __________
   5. Worked for a foreign company outside of Hungary. Which one and where?
      ____________________________
   6. Worked for a joint venture. Which one? __________________________
   8. Other (Specify) ____________________________
   9. N/A

45. How many people were employed where you last worked?
   0. 25 or fewer 1. 25 to 50 2. 50 to 100 3. 100 to 200
   4. 200 to 500 5. 500 to 1000
   6. More than 1000

46. What was your occupation and position in your last job? __________

47. Are you producing the same product in your current business that was produced in your last several jobs? (Formal or informal jobs)
   0. The same
   1. Very similar
   2. Related but different
   3. Completely different
   9. N/A

48. What is the primary reason why you started up this business? (pulled to opportunity or pushed to it by problems elsewhere)
   0. Lost job, was laid off, or expected to be laid off
   1. Frustrated with work in state-owned enterprises--no future there
   2. Few job opportunities elsewhere, private sector was only option
   3. Previous salary was too low, thought could make more in private sector
   4. Wanted to put training to use
   5. Saw a profitable opportunity and took it
   6. Laws on private enterprise were changed
   7. Parents/relatives were in private business
   8. Other (Specify) ____________________________
   9. N/A
49. What were your primary personal goals in starting up this business? (Interviewers, choose one that best matches the person’s answer. Let them tell you in their words)

0. Achievement—wanted to use the skills you have
2. Status/prestige—wanted to move up in the world
3. Independence—wanted to work on your own
4. Power—wanted to be in charge
5. Money—wanted to earn more money than was before
6. Economic necessity—had few other choices
7. Career/security—this route offered the best future
8. Other (Specify) ____________________________
9. N/A

50. Which of the following descriptions best fits you? (Interviewers, read them the list. They can choose 3)

0. A high achiever, easily bored with routine, restless
1. A practical person with practical skills
2. Highly disciplined, committed to hard work
3. A risk-taker, willing to live with uncertainty
4. Like to feel in control of what is going on
5. Self-confident, fairly sure of success
6. Independent, a loner, somewhat separate from others
7. Grew up in a difficult, troubled family
8. Other (Specify) ____________________________
9. N/A

51. If you had the opportunity to start over, would you choose this business again?

0. Would not start this business again if I could choose again
1. Would start another business in a different industry. Which industry?________________________
2. Would start again in the same industry
3. Would not start any private business.
8. Other (Specify) ____________________________
9. N/A

52. Are you a member of a trade association or other business association?

0. No 1. Yes 9. N/A

If so, name of association: ____________________________

53. What benefits do you receive as a member? (For example: information on markets, technology, laws and regulations, political representation, education, insurance, special low-interest loans or other financial services)

III. FIRM PROFILE

A. LABOR AND LABOR COSTS (enter 0 for none; leave blank if no answer)

1. Profile of Labor Force

54. Owners and other family members who work full-time
55. Full-time wage workers and contract employees
56. Full-time Apprentices
57. Total, all full-time workers including owners and family members
58. Number of full-time workers including owners and family members when started up.
59. Number of full-time workers including owners and family members 12 months ago.
60. Part-time owners and family members
61. Part-time wage workers and contract employees
62. Total, all part-time workers
63. Average number of hours worked per week by all part-time workers combined.

Gender Profile
64. Male full-time workers
65. Female full time workers

Skills Profile
66. Workers directly operating production machinery
67. Workers providing ancillary support e.g., moving materials within the plant, packaging the product.
68. Administrative workers, e.g., bookkeepers, sales persons, etc.
69. Technical/engineering support workers
70. Other (Specify)
71. What percentage of your workers are skilled workers? ______ percent
72. Are your current workers as highly skilled as you need/want them to be?
   0. No Comment: ________________________________
   1. Yes Comment: ________________________________
   8. Other (Specify) ________________________________
   9. N/A

73. Do you have problems recruiting unskilled workers?
   0. No
   1. Yes What problems? ________________________________
   8. Other (Specify) ________________________________
   9. N/A

74. Do you have problems recruiting skilled workers?
   0. No
   1. Yes What problems? ________________________________
   8. Other (Specify) ________________________________
   9. N/A

75. Do you provide any training to your workers?
   0. No. Why not?
   1. Yes. Please describe. (What kind, to whom, how often for what duration?)
   8. Other (Specify) ________________________________
   9. N/A
76. Where have most of your workers learned the skills they use in your company?
0. In the school system
1. In training courses outside the formal education system
2. From on-the-job training in previous jobs
3. From on-the-job training in your company
4. Other (Specify) ________________________________
5. N/A

77. What do you think would be the best approach to training and upgrading the skills of workers in Hungary?

78. Are your workers represented by a union or a worker's council?
0. No Why not? ______________________________________
1. Yes What kind? _____________________________________
2. Other (Specify) ____________________________________
3. N/A

79. Are your workers protected against losing their jobs, i.e., are you prohibited from firing a worker if you want to?
0. No, workers have no protection against losing their jobs
1. Yes, workers are protected by job security laws in Hungary
   If so, what are the laws? ________________________________

2. Yes, workers are protected by other measures. What measures?
3. Other (Specify) ____________________________________
4. N/A

2. Labor Costs

What is the total cost of labor of your business? (including wages, bonuses, allowances, taxes and social security)

80. __________ forint per week/month (specify time unit)
81. __________ the total wage bill in US$ per month (figure later)

82. Of the total wage bill, how much do you pay directly to workers as salaries?
   __________ forint per week/month (specify time period)

83. Of the total wage bill, how much do you pay directly to workers in allowances and bonuses?
   __________ forint per week/month (specify time period)

84. Of the total wage bill, what percent do you pay for taxes on wages?
   ______ percent

85. Of the total wage bill, what percent do you pay for social security?
   ______ percent
86. How do you decide wages for your workers?
0. You decide yourself
1. You pay the minimum wage set by the State
2. You have to bargain with workers unions or councils
3. The market—demand and supply for workers—sets the wage
4. The amount that you pay is determined by the amount the state-owned enterprises pay, i.e., you pay some percentage more
8. Other (Specify) ____________________________________________
9. N/A

87. What kinds of compensation/benefits do all workers receive in Hungary?
0. None
1. Retirement/pension benefits
2. Health insurance
3. Housing allowance/allotment
5. Transportation allowance
6. Maternity
7. Vacation with pay, # of days?
8. Other (Specify) __________
9. N/A

88. What additional kinds of compensation/benefits have you chosen to give to your workers?
0. None
1. Retirement/pension benefits
2. Health insurance
3. Housing allowance/allotment
5. Transportation allowance
6. Maternity
7. Vacation with pay, # of days?
8. Other (Specify) __________
9. N/A

8. PHYSICAL CAPITAL
1. Land and Buildings

89. How many square meters of floor space does your firm occupy?

90. How did you obtain the factory space (building) you now occupy?
0. Bought it. What year? ____________ From whom? ______________________
2. Inherited it.
3. It belongs to a family member
4. Lease it on a multi-year basis. From whom? ______________________
5. Lease it on annual basis. From whom? ______________________
6. Lease it on a monthly basis. From whom? ______________________
7. Purchased the lease from the State or local government.
8. Other (Specify) ______________________

91. How did you obtain the land your business sits on?
0. Bought it. What year? ____________ From whom? ______________________
2. Inherited it.
3. It belongs to a family member
4. Lease it on annual basis. From whom? ______________________
5. Lease it on a multi-year basis. From whom? ______________________
6. Lease it on a monthly basis. From whom? ______________________
7. Purchased the lease from the State ______________________
8. Other (Specify) ______________________
92. Are the land and building space you now have sufficient for your needs?

0. Too small
1. Just right
2. Too big
3. Poorly located
4. Poor quality
5. Other (Specify) ____________________________
6. N/A

93. Is it possible to rent or purchase a larger building or more land for your business needs?

0. No. Why not?
1. Yes, it's available and affordable
2. Yes, it's available but it's too expensive
3. Other (Specify) ____________________________
4. N/A

94. What are the main production machines in your business? Name, manufacturer, date of manufacturer, rated capacity (of throughput or output per hour).

<table>
<thead>
<tr>
<th>Machine</th>
<th>Manufacturer</th>
<th>Year Made</th>
<th>Capacity (Machine)</th>
<th>Replacement Cost Today</th>
<th>In which Currency (Machine)</th>
<th>(if not local)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td></td>
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<td>4.</td>
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<tr>
<td>5.</td>
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<td></td>
</tr>
</tbody>
</table>

95. What is the average age of your equipment?

0. Less than one year old
1. 1 - 3 years old
2. 3 - 5 years old
3. 5 - 10 years old
4. 10 - 20 years old
5. More than 20 years old
6. Other (Specify) ____________________________
7. N/A

96. Have you purchased equipment (new or used) since start-up? (Other than initial investment)

0. No 1. Yes 9. N/A

97. How did you finance the purchase of your new equipment?

0. Profits from this business
1. Profits from other businesses
2. Credit What kind and from whom? ____________________________
3. Personal loan
4. Other: ____________________________
5. N/A
98. Who are the main suppliers of equipment for your enterprise?
   0. Domestic producers
   1. Producers in ruble areas
   2. Producers in non-ruble areas
   3. Other (Specify) ______________________________
   4. N/A

99. Are there problems in procuring imported equipment?
   0. No
   1. Yes. If so, what are they? ______________________________
   2. Other (Specify) ______________________________
   3. N/A

100. Is domestic equipment available that meets your needs?
    0. No
    1. Yes
    2. Other (Specify) ______________________________
    3. N/A

101. What problems, if any, are there with domestically-made equipment?
    0. It's of poor quality
    1. It's more expensive than the imported ones
    2. The specifications are wrong for what you need
    3. The equipment you need is not manufactured in Hungary
    4. Other (Specify) ______________________________
    5. N/A

102. Are the spare parts and repair services that you need easy to get?
    0. Very difficult
    1. Difficult
    2. Easy
    3. Very easy
    4. If difficult, why? ______________________________
    5. N/A

103. From whom do you buy spare parts and purchase repair services?
    0. Import directly from the manufacturer who makes the machine
    1. Buy them directly from producers of domestic machines
    2. Buy them from domestic retailers of spare parts
    3. Buy them second-hand or take them from discarded machines
    4. Make them myself
    5. Other (Specify) ______________________________
    6. N/A

104. How do you account for depreciation of capital equipment?
    0. Written off as current expense
    1. Amortized at an annual rate of ______________________________
    2. Other (Specify) ______________________________
    3. N/A
C. **FINANCE AND THE COST OF CAPITAL**

Please check the following items to describe how you obtained and maintained the funding and financing required to initiate and maintain the ownership of your business. Check as many boxes as are appropriate.

<table>
<thead>
<tr>
<th>Source of funding</th>
<th>105. Initially or during the first six months of operations</th>
<th>106. Between the first six months and first year operations</th>
<th>107. Between the first and third years of operations</th>
<th>108. After three years in business</th>
</tr>
</thead>
<tbody>
<tr>
<td>0. Own savings</td>
<td>___</td>
<td>___</td>
<td>___</td>
<td>___</td>
</tr>
<tr>
<td>1. Family</td>
<td>___</td>
<td>___</td>
<td>___</td>
<td>___</td>
</tr>
<tr>
<td>borrowing</td>
<td></td>
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<tr>
<td>2. Borrowing</td>
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<tr>
<td>from friends</td>
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<tr>
<td>3. Government</td>
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<tr>
<td>program</td>
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<tr>
<td>4. Commercial</td>
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<tr>
<td>or investment</td>
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<tr>
<td>bank loan</td>
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<tr>
<td>5. Cash flow from</td>
<td>___</td>
<td>___</td>
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<tr>
<td>the business</td>
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<tr>
<td>6. Supplier</td>
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<tr>
<td>credits</td>
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<td>7. Other (Please</td>
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<tr>
<td>specify)</td>
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<tr>
<td>9. N/A</td>
<td>___</td>
<td>___</td>
<td>___</td>
<td>___</td>
</tr>
</tbody>
</table>

/109. What is your biggest problem with financing your business?

__________________________________________________________________________

110. Are you a client of a bank?

0. No  1. Yes  Name of bank(s): ____________________________

111. How far do you have to travel to get to the nearest bank branch?

___________________ Kilometers
112. What banking services have you used? (Check as applicable)

0. _____ Savings account
1. _____ Checking account
2. _____ Letters of credit
3. _____ Bills of collection
4. _____ Working capital
5. _____ Investment credit
6. _____ Equipment lease finance
7. _____ Insurance (Type?)
8. _____ Other
9. _____ None

113. Are you satisfied with the banking services you have received?

0. No 1. Yes

Comments:

114. If no, indicate which factors you would like to see improved, ranking by degree of importance to your business (1 = very important, 2 = less important)

0. _____ Transaction speed
1. _____ Fees/price of services
2. _____ Availability of services
   (Name most important: ____________________________)
3. _____ Confidence/trust
4. _____ Reliability/accuracy
5. _____ Other (Specify)

115. If a western bank offered these services, would you rather use them than a Hungarian bank?

0. No 1. Yes

If so, why? _______________________________________

116. Are you aware of any World Bank lines of credit?

0. No 1. Yes

If so, where did you hear about it? _______________________

117. Have you used or tried to use World Bank credit lines?

0. No 1. Yes

If no, why not?

1. Yes If so, what has your experience been? _________________

118. Since start-up, have you tried to get a loan from a bank or promotion agency?

0. No Why not?

1. Yes, but not successful. What kind of loan? ________________

Why not successful? ___________________________________

2. Yes, short term loan received (12 months or less)

Terms of loan: interest rate _____ term _____

name of bank ________________________________

3. Yes, long term loan received.

Terms of loan: interest rate _____ term _____

name of bank ________________________________

8. Other (Specify) ________________________________

9. N/A
119. If a long-term loan were available from a bank or government agency at current interest rates of ______ percent, would you apply for one?

0. No Why not? ____________________________________________
1. Yes
8. Other (Specify) __________________________________________
9. N/A

120. Assuming you are willing to pay current interest rates, how difficult is it currently to get a long term loan from a bank?

0. Very easy
1. Fairly easy
2. Fairly difficult
3. Very difficult
8. Other (Specify) __________________________________________
9. N/A

121. The main difficulty in getting a loan is:

0. Paperwork
1. Not enough money to be loaned
2. Size of loans available is not large enough
3. Bankers prefer to make larger loans
4. Lenders prefer favored clients, those who have large deposits or are long-term clients
5. Lenders do not like my kind of business
6. Lenders require more collateral than I have
Details on collateral: _________________________________________
8. Other (Specify): __________________________________________
9. N/A

122. Do you have problems in getting foreign exchange?

0. No 1. Yes 9. N/A

If so, what problems? _________________________________________

D. RAW MATERIALS, INTERMEDIATE INPUTS AND ENERGY CONSUMPTION

123. What are the principle raw materials and intermediate inputs used in your product? (list in physical units per year, month or week) (Imported means imported directly or by a retailer)

<table>
<thead>
<tr>
<th>Raw Materials and Inputs</th>
<th>Quantity</th>
<th>Time Period</th>
<th>Price per Unit</th>
<th>Supplier</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td># of units</td>
<td>(week/month/year)</td>
<td>$/unit</td>
<td>(private, state)</td>
<td>(Domestic, Imported)</td>
</tr>
<tr>
<td>1.</td>
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</tbody>
</table>

124. What proportion of your raw materials or intermediate inputs are imported, either by you or an importer? ________ percent

125. Do you have problems obtaining the imported raw materials and intermediate inputs you need?

0. No 1. Yes 9. N/A

If so, what problems? _________________________________________

126. Since start-up, is the proportion of your raw materials and inputs that is imported:

0. about the same 1. greater 2. less 9. N/A

If it has changed, why? _______________________________________
127. Do you have problems obtaining local raw materials and intermediate inputs?

0. No 1. Yes 9. N/A

If yes, what problems? ________________________________

128. What is the amount of energy consumed by your factory? (electricity, coal, gas oil in physical units) (Specify time units: per year, month or week)

What are the main problems with public services (transportation roads, railway water and sewage, electricity, communications-phone, telegraph, etc.) your business faces?

129. Service: ____________ 130. Service: ____________

0. none 1. occasional interruption 2. frequent, longer or serious interruptions 3. too expensive 4. delay in obtaining 8. other (Specify) ____________

9. N/A

98. N/A

E. PRODUCTION AND CAPACITY UTILIZATION

1. Production

131. How many hours per week does your company operate? ____________ hours

132. How many hours per week could your company operate if it were at full capacity? (With as many orders as you could fill with the same workers and equipment)

__________ hours

Changes in Production

133. In the past 3 months, how has your production volume changed? For what single most important reason? (circle only one)

0. No significant change
1. Increased, because foreign exchange (inputs) more available
2. Increased, because local raw materials are more available
3. Increased, because demand has increased
4. Increased, because of entering new markets
5. Increased, because imported goods now are more expensive
6. Increased, because production in state-owned enterprises has declined
7. Increased, other reason (specify) ________________________________
8. Decreased, because demand is weak ________________________________
9. Decreased, because of competition from imports
10. Decreased, because of increased domestic competition
11. Decreased, because of high costs of imported inputs (lack of working capital)
12. Decreased, because of high costs of local inputs (lack of working capital)
13. Decreased, because of labor problems
14. Decreased, other reason (specify) ________________________________

99. N/A
134. At present, is the firm selling everything that it produces?

0. No, inventories are piling up
1. Yes, and you could sell more if you had more orders
2. Yes, but couldn't sell much more even if demand were greater.
8. Other (Specify): ________________________________
9. N/A

135. If you cannot sell all that you can make, have you lowered your prices?

0. No 1. Yes 9. N/A

If not, why not?
If so, what was the result?

136. If you could sell more, than you can (i.e., if demand is high) have you raised your prices?

0. No 1. Yes 9. N/A

If not, why not?
If so, what was the result?

137. Adjusting for inflation, how has the retail price of your most important product changed in the past 10-12 months?

0. It has not changed
1. It has increased. By what percent? ________ %
2. It has decreased. By what percent? ________ %
If it has changed, why has it changed?

8. Other (Specify) ________________________________
9. N/A

138. Adjusting for inflation, how has the retail price of your second most important product changed in the past 10-12 months?

0. It has not changed
1. It has increased. By what percent? ________ %
2. It has decreased. By what percent? ________ %
If it has changed, why has it changed?

8. Other (Specify) ________________________________
9. N/A

139. How do you set the price of your product?

0. I set it based on production costs
1. I charge the same as my competitors
2. I set it based on the profit level I want
3. The price of my product is fixed
4. Trial and error
5. A mix of the above (which ones? ________ )
8. Other (Specify) ________________________________
9. N/A
140. Have you changed your mix of products since start-up?

0. No 1. Yes 9. N/A

New products (Describe them, why did you choose this product? Source of design?)

Producing more of ___________________________________________
Producing less of ___________________________________________
Stopped production of _________________________________________

141. Have you changed, in any way, your methods of production since start-up?

0. No 1. Yes How? 8. Other (Specify) ___________________________
9. N/A

142. What are your hopes or plans for the company in the next 5 years? (Check all applicable items)

0. Expand the company size
1. Expand into new markets, locally _______ abroad _______
2. Get access to better technology/improve product quality
3. Expand into new product/service areas (which ones? ______)
4. Become listed on the stock exchange
5. Find a local partner
6. Find a foreign partner
7. Stay roughly the same, maintain the company as it is
8. Other (Specify) _________________________________________
9. Sell the company
10. Invest abroad (Where? ______________________________________)
11. Reduce production

F. SALES AND MARKETING

1. Profits

143. Approximately what was the total sales revenue of your factory in August? ______________ forint

144. Of total sales, what percentage are forints _____%, rubles _____%, hard currency _____%?

145. Is the business currently making profits? (i.e., is owner getting any income out of it?)

0. No 1. Yes 9. N/A

146. What do you do with your profits?

0. Invest them in this business
1. Invest them in another business
2. Save them
3. Spend them
8. Other: ___________________________________________________
9. N/A
147. Is the business more or less profitable now than in the first few months after start-up?

0. About the same  1. More profitable
2. Less profitable  8. Other (Specify) _______________________
9. N/A

Why? __________________________________________________________

148. Are you satisfied with the profits of this business?

0. Unsatisfactory and unreasonable  1. Reasonable
2. Below the potential of this business  3. Unpredictable
4. Better than I expected  8. Other (Specify) _______________________
9. N/A

149. Through which channels in Hungary do you sell your products?

1. Sell directly from your own shop  2. State-owned enterprises (as inputs)
3. Other private industries (as inputs)  4. State-owned enterprises (as finished goods)
5. Private shops, retailers (as finished goods)  6. Government (as finished goods)
7. Private middlemen or agent (finished goods or inputs?)  8. Other (Specify) _______________________
9. N/A

150. Where are most of your products sold? (circle one only)

1. Locally  2. In surrounding towns  3. Nationally
4. Other countries in Central Europe  5. Western Europe
6. The USSR  7. Other countries overseas  8. Other (Specify) _______________________
9. N/A

151. How have your markets changed in the past 12 months? (Can answer more than one)

0. Domestic sales have increased  1. Domestic sales have decreased
2. Ruble sales have increased  3. Ruble sales have decreased
4. Hard currency have increased  5. Hard currency have decreased

152. Describe the typical person who buys your products? (If you sell final products)

1. Rural people/farmers  2. Low-income urban people
3. Middle-income urban people  4. Upper-income urban people
5. Other (Specify) _______________________
9. N/A
153. Do you have problems distributing your product?

0. No 1. Yes 8. Other (Specify) ________________________________ 9. N/A

If yes, what are they? ________________________________

154. Are there regulations regarding distribution channels you have to use for your products?

0. No 1. Yes 8. Other (Specify) ________________________________ 9. N/A

If yes, what are they? ________________________________

3. Exports

155. Do you export your product (directly or through traders)?

0. No 1. Yes, export directly 2. Yes, export through others 8. Other (specify): ______________ 9. N/A

156. If yes, about what proportion of your production is exported: __________ percent

[coder: leave blank if not answered]

157. What percentage of your exports are in rubles _____% (Assume rest is in hard currency)

158. If you export, what changes in your products have you made to ensure that they are competitive in world markets?

0. No changes, my products are competitive without changes 1. I have switched product lines 2. I have upgraded the quality of my products 3. I have switched export markets to stay competitive From which countries to which countries? 4. I have lowered my prices to undersell the competition 8. Other (Specify) ________________________________ 9. N/A

159. How do you decide which products to export, what quality they should be and what prices to charge?

____________________________________________________________

160. If you are exporting, what are the main obstacles that you face? (For example: taxes, paperwork, knowledge, costs)

____________________________________________________________

161. If you are not exporting, have you considered it?

0. No 1. Yes 8. Other (Specify) ________________________________ 9. N/A

If no, why not? ________________________________
4. Competition

162. Who are your firm's main competitors? (circle one)

0. None
1. Other small private firms
2. Large private firms
3. State enterprises
4. Cooperatives
5. Foreign-owned firms
6. Foreign-local joint ventures
7. Imports
8. Other (Specify)
9. N/A

163. Has the number of firms producing in your main product become greater since you started-up?

0. No
1. Yes
8. Others (Specify)
9. N/A

164. How many other firms now produce in your main market in Hungary?

0. None
2. 1-10
3. 10-50
4. 50-100
5. More than 100
8. Others (Specify)
9. N/A

165. How many other firms now produce in your markets abroad?

0. None
2. 1-10
3. 10-50
4. 50-100
5. More than 100
8. Others (Specify)
9. N/A

166. In your main market, why do you think your customers buy your product instead of your competitors'? (Circle the one most important reason)

1. My price is lower than my competitors'
2. My product is better designed, of higher quality and is more reliable
3. My product is the only one of its type on the market
4. I deliver my product on time
5. I actively advertise and market my product
6. My business is conveniently located
7. My reputation, people know me
8. Other (Specify)
9. N/A

IV. Government Policies and Regulations

A. Registration Information

167. What kinds of registration, licenses, permits does this firm have?

________________________________________________________

________________________________________________________
168. Did you have problems obtaining any of the licenses and permits that you have?

0. No
1. Yes
8. Other (Specify) ________________________________________________________
9. N/A

If so, what kinds of problems with which licenses or permits? (Be specific) ________________________________________________________

169. How long did it take you to get all of the licenses and permits that you needed?

0. Same day
1. Less than a month;
2. 1-3 months
3. 3-6 months
4. more than 6 months
8. Other (Specify) ________________________________________________________
9. N/A

170. How have privatization policies affected your business?

____________________________________________________________________
____________________________________________________________________

B. **Taxes**

*Interviewers, once you are sure that you know the answers for the next six questions, you can skip them but write them out for the first five interviews*

/171. What types of taxes do you pay, other than those connected with payroll and workers? (For example: VAT, sales, income, inventory, import or export taxes...)

____________________________________________________________________
____________________________________________________________________

172. How have these changed in the past two years?

0. Not at all
1. Minor changes
2. Significant changes, explain ____________________________________________

/173. What are the main regulations regarding taxes on profits from your enterprise?

____________________________________________________________________
____________________________________________________________________

/174. What is the tax treatment for profits reinvested in the company?

____________________________________________________________________

/175. Are there any special incentives for investment in new machinery and equipment?

0. No
1. Yes, explain ________________________________________________________
9. N/A
176. Have you used any of these incentives?
0. No 1. Yes 9. N/A
If so, which ones? ________________________________

V. CONCLUSIONS

177. What are the major problems facing someone trying to start a new business today in your country?
_________________________________________________________

178. How would you rate the attitude of government and public officials toward private business and profit-making?
0. very negative 1. negative
2. neutral 3. positive
4. very positive
Explain: __________________________________________________

179. How would you rate the attitudes of managers of state firms toward private business and profit-making?
0. very negative 1. negative
2. neutral 3. positive
4. very positive

180. How would you rate the average citizen's attitude toward private business and profit-making?
0. very negative 1. negative
2. neutral 3. positive
4. very positive
Explain: __________________________________________________

181. In your view, what should the government do to make it easier for you or someone who is starting a new business? (includes policies and special programs)
_________________________________________________________

182. Have you heard about any special programs to help private business with credit or with training?
0. No 1. Yes
8. Other (specify) __________________________________________
9. N/A
If so, which program and what is your opinion of it?
_________________________________________________________
183. In your view, what is the future of the private sector in Hungary?

Interviewer's notes on the Entrepreneur and/or the Business:

_________________________________________________________________________
_________________________________________________________________________
_________________________________________________________________________
_________________________________________________________________________
_________________________________________________________________________
Coding List For Question on Problems

Demand
1. People don’t have enough money (generally)
2. People aren’t buying because it is the off season
3. Too many other firms in the same business
4. Too many imports
9. Other demand problems (specify)

Raw Materials and Inputs
11. Can’t get enough local raw materials and inputs
12. Quality of raw materials and inputs is poor
13. Price of local raw materials and inputs is too high
14. Can’t get enough imported raw materials and inputs
15. Price of imported raw materials and inputs is too high
16. Tariffs on imported raw materials are too high
19. Other; (specify)

Technology, Equipment
21. Equipment is old and needs replacing or updating
22. Replacement costs are too high
23. Can’t get spare parts
24. Local equipment is inferior, can’t afford imports
25. Repairs are difficult to do or get done
29. Other; (specify)

Finance
31. Have to give too much credit to customers
32. Can’t get credit for raw materials or working capital
33. Can’t get credit for equipment
34. Banks are too difficult to deal with (guarantees are too high, too much collateral, other)
35. Interest rates are too high
36. Cash flow problems due to delayed clearing of payments to threat the bank
37. State enterprises are not paying on time
39. Other; (specify)

Labor, Management
40. Lack of skilled workers; workers don’t have the right skills
41. Lack of unskilled workers
42. High wages and benefits for skilled workers
43. High wages and benefits for unskilled workers
44. Not allowed to lay workers off
45. Inadequate management skills. In which area? 
46. Not permitted to increase wages sufficiently to attract appropriate labor
47. Workers unmotivated or lazy
49. Other; (specify)

Infrastructure
50. Lack of or frequently interrupted electricity
51. Inadequate telecommunications, specifically
52. Inadequate roads for transport
53. Transportation costs are too high
54. Shipping by land, sea and air is very difficult to arrange
55. Shipping by land, sea and air is very expensive
56. Factory space is inadequate and getting a larger space is too expensive
57. Factory space is inadequate and a larger space is not available
58. Warehouse space is not available
59. Other; (specify) ________________________________

Business Environment

60. Taxes
61. Regulations, licensing, permits
62. Obtaining foreign exchange
63. Rules and policies change too often
64. Standards and quality requirements are unreasonable (e.g., for gov't. procurement)
65. Government rules and regulations are too costly to comply with
66. Other; business environment (specify) ________________________________

Marketing and Distribution

70. Too few distributors
71. Distributors won't handle the firm's product
72. Distributors will pay too little for the firm's products
73. Difficult to gain access to retail market directly
79. Other; (specify)
80. Other problems; (specify) ________________________________

99. N/A = not asked, not applicable, no answer
Topics for Qualitative Information

Write out or type up those facts about this firm that are of interest and that illustrate a general point about private manufacturing that you think is important. If you write, please write clearly—remember that someone at the other end will have to read what you have written. Be specific: problems with taxes is useless if we don’t know which taxes and what problems. Whether writing or typing, please start your paragraph with the word underlined so that we can collate easily at the end. Topics that have proven helpful in writing up the report are the following. If you need to add others, please do so. Just be consistent with your topic word.

1. Origins of firm
2. Backgrounds of Entrepreneurs
3. Equipment/Production
4. Labor-skills/training, labor markets, labor culture
5. Raw materials—problems in obtaining, quality
6. Real estate—lease terms, availability, choice of location
7. Effect of govt policies on firms, details of regulations
8. Taxes
9. Attitudes toward private profit making
10. Relationships with state firms, SOEs, buying from, selling to
12. Finance—how done it, current problems with
13. What are the firm’s major constraints and problems?
14. Prospects—how do you rate this firm’s prospects for the future and why? How competitive is this firm and why? If prospects are poor, what is the main reason? If bright future, what is the key variable? The person, competition or lack thereof, favorable policies? What are your conclusions about this firm?
15. Needs for assistance—what do you think is needed and in what form and delivered by whom?
16. What should the govt. do to assist private manufacturers?
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</tr>
</thead>
<tbody>
<tr>
<td>196</td>
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</tr>
<tr>
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