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LEGAL ASPECTS OF DOING BUSINESS IN HUNGARY

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Legal Aspects of Doing Business in Hungary

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Glossary

This report contains a number of terms and abbreviations along with references to legislation all of which are listed in the following glossary.

AFA	General turnover tax
Betéteti Társaság (Bt)	Limited partnership
CMEA	Council for Mutual Economic Assistance
EBRD	European Bank for Reconstruction and Development
EC	European Community
ECU	European Currency Unit
EEAF	Environmental Enterprise Assistance Fund
EIB	European Investment Bank
EPC	European Patent Convention
Egyesülés	Trade or business association
FIDESZ	Young Democrats
FTC	Foreign trade companies
Felszamolas alatt (fa)	Undergoing liquidation
GATT	General Agreement on Trade and Tariffs
GVH	Competition Agency
HUF	Hungarian forints
Hìrlapkiadò	Newspaper and journal publishing
IAS	International Accounting Standards
IBRD	International Bank for Reconstruction and Development
ICC	International Chamber of Commerce
IER	Ministry of International Economic Relations
Kereskedelmi Bank Rt	Commercial and Credit Bank
Koriátoit Felelösségü Társaság (Kft)	Limited liability company
Közkereseti Társaság (Kkt)	Unlimited partnership
Közös vállalat (Kv)	Joint venture
MAHART	Shipping
MALÉV	Hungarian Airlines
Magyar (MATÁV)	Hungarian Telecommunications
Távkuözlési Vállalat	Hungarian Telecommunications Company
MÀV	State railway
MIGA	Multilateral Investment Guarantee Agency
MOL	Oil and gas
MVM	Electricity
Magyar Hite Bank Rt	Hungarian Credit Bank
Magyar Köztársaság	The Republic of Hungary
NBH	National Bank of Hungary
NOI	National Office for Inventions
OECD	The Organisation for Economic Cooperation and Development
OPIC	Overseas Private Investment Corporation
PCT	Patent Cooperation Treaty
PHARE	Poland-Hungary Assistance for Restructuring the Economy — EC assistance programme
PIFS	Pre-investment Feasibility Studies

Részénytársaság (Rt)	Public limited company
SIB	State Inspectorate of Banks
SIS	State Inspectorate of Securities
SBM	Supervisory Board for Mining
SBS	State Banking Supervision
SISA	State Insurance Supervisory Agency
SPA	State Property Agency
SPMC	State Property Management Corporation
SSS	State Securities Surveillance Board
Szerencsejàtèk	Gambling
TDP	Trade and Development Programme
TIPS	Training for Investment Personnel Scheme
Tankŏnyvkiadó	Textbook publishing
USA and US	United States of America and United States
VAT	Value Added Tax

Table of Legislation

Acts

Accounting Act (Act No XVIII of 1991) 44, 45, 46, 47, 48, 49, 50, 55, 67
paras 43–50 47
Annex 3 48
Banking Act (Act No LXIX of 1991) 81, 82, 83, 86
Bankruptcy Act (Act No IL of 1991) 44, 46, 50, 51, 52, 53, 54, 55, 56, 57, 58
Business Profits Tax Act (Act No IX of 1988) 6
Civil Code of the Republic of Hungary (Act No IV of 1959) 16, 20, 22, 24, 44, 49, 53, 54, 59, 60, 61, 62, 63, 64, 66, 74, 76, 77, 78, 79, 121
Civil Procedure Code (Act No III of 1952) 11
Companies Act (Act No VI of 1988) 5, 11, 25, 26, 28, 29, 30, 32, 34, 35, 36, 45, 49, 56, 110
Chaps II, VI and VII 45
Company Tax Act (Act No LXXXVI of 1991) 6, 46, 47, 50, 67
Competition Act (Act No LXXXVI of 1990) 12, 13, 14, 19
Concessions Act (Act No XVI of 1991) 21, 22, 23, 24, 115
Conversion of Economic Organisations and Business Associations Act (Transformation Act) (Act No XIII of 1989) 110
Copyright Act (Act No III of 1969) 18
Employees Co-ownership Programme Act (Act No XLIV of 1992) 112, 121
Environment Act (Act No II of 1976) 19
Entrepreneurial Profits Tax Act (Business Profits Tax Act) (Act No IX of 1988) 6
Foreign Investment Act (Act No XXIV of 1988) 5, 6, 7, 8, 12, 71, 79, 102, 110
Labour Code (Act No XXII of 1992) 88, 89, 90, 92, 93, 94, 95
Land Act (Act No I of 1987) 74
Law on Fixing Prices (Act No LXXXVII of 1990) 12
Law on Protection of State Property (Act No VIII of 1990) 78
Local Taxes Act (Act No C of 1990) 79
National Bank of Hungary Act (NBH Act) (Act No LX of 1991) 81
Penal Code (Act No IV of 1978) 49, 50
Personal Income Tax Act (Act No XC of 1991) 71
1992 Privatisation Acts 110, 112
Privatisation Amendment Act 1992 (Act No LV of 1992) 111, 121
Privatisation of State-Owned Companies in the Retail Trade, Catering and Consumer Services (Retail Privatisation Act) (Act No LXXIV of 1990) 117, 122
Prohibiting of Unfair Market Conduct Act (Competition Law Act) (Act No LXXXVI of 1990) 12, 13, 14, 19

Promotion of Employment and Provisions for the Unemployed Act (Act No IV of 1991) 90
Protection of Inventions by Patent Act (Act No II of 1969) 16
Protection of Registered Design Patents Act (Act No XXXVIII of 1991) 17
Protection of Topograhy of Microelectronic Semiconductor Products Act (Act No XXXIX of 1991) 16
Protection of the Human Environment Act (Environment Act) (Act No II of 1976) 19
Restitution Act (Act No XXV of 1991, Act No XXIV of 1992, Act No XXXII of 1992) 80
Securities and Stock Exchange Act (Act No VI of 1990) 11, 45, 84, 85, 86
State Finances Act (Act No II of 1979) 86
State Property Agency Act 1992 (Act No LIV of 1992) 50, 110, 111, 113, 118, 120, 121
State Property Management Corporation Act 1992 (Act No LIII of 1992) 113, 114, 115, 118, 119, 120, 122
Telecommunications Act (Act No LXXII of 1992) 24
Trademarks Act (Act No IX of 1969) 18
Transformation Act (Act No XIII of 1989) 110
Water Management Act (Act No IV of 1964) 19

Decrees and Ordinances

Decrees

Decree No 9 of 1969 (XII.29) of the Minister of Culture on Execution of the Copyright Act 15
Law Decree No 1 of 1974 on Foreign Exchange Management 15
Decree of Government No 21/1976 (VI.29) on Customs Tariff 98
Decree of Government No 7/1978 (II.1) on Supply and Work Contracts of Business Organisations 62
Law Decree No 8 of 1978 on the Applications of the Civil Code in Relation to Foreign Economic Relations 64, 65
Law Decree No 28 of 1978 on Protection of Industrial Designs 17
Law Decree No 13 of 1979 on Private International Law 11
Decree of the Council of Ministers No 56/1981 (XI.118) on the Control of the Production of Dangerous Waste Materials and Activities Relating to their Destruction 20
Decree No 4/1984 16
Decree No 11/1986 16
Decree of Government No 21/1986 (VI.2) on the Protection of the Cleanliness of Air 20
Decree of the Council of Ministers No 56/1986 (XII.10) on the State Insurance Supervisory Agency 86
Decree No 1/1987 (XII.29) of the Minister of Trade on Carrying on Foreign Trade Activity 97
Decree No14/1987 (IV.13) of the Minister of Finance on Individual Issues Relating to the State Insurance Supervisory Agency 86
Decree of the Council of Ministers No 55/1987 (X.30) Regarding the Import from Abroad of Substances Dangerous to the Human Environment 20
Decree No 1/1989 (I.18) of the Minister of Trade 97
Decree No 3/1989 (II.26) of the Minister of Trade on Commercial Representative Offices of Foreigners and on their Information and Service Offices in Hungary 41
Decree of Government No 61/1990 (X.1) on Licensing of Trade in Various Internationally Controlled Products and Technologies 98
Decree of Government No 111/1990 (XII.23) on Anti-Dumping Proceedings 96
Decree of Government No 112/1990 (XII.23) on Export and Import of Goods, Services and Rights representing Material Value 98

Decree of Government No 113/1990 (XII.23) on Measures for Market Production Concerning the Import of Commodities, Services and Rights Representing Material Value 98

Decree of Government No 48/1991 (III.27) on the Export, Import and Re-export of Military Equipment and Services 98

Decree of Government No 136/1991 (X.25) on the Restriction of Domestic Sale in Return for Foreign Currency 77

Decree of Government No 171/1991 (XII.27) on the Acquisition of Real Estate by Foreigners 75

Decree of Government No 46/1992 (III.13) on the Order of Auditing 49

Decree of Government No 126/1992 (VIII.28) on Business Organisations Remaining Wholly or Partly in State Ownership 114

Joint Decrees

Joint Decree No 39/1976 (XI.10) of the Minister of Finance and Minister of Foreign Trade on the Detailed Rules of Customs Law and Customs Procedure 98
arts 71–89 101, 102

Joint Decree No 4/1969 (X11.28) issued by the President of the National Committee for Technical Development and the Minister of Justice on Execution of the Protection of Inventions by Patent Act 16, 18

Treaties and Conventions

Treaties

Patent Cooperation Treaty (PCT) 16

Treaty of Trianon 1920 1

Conventions

Berne Convention 18

European Patent Convention (EPC) 1973 16

Geneva Convention on International Commercial Arbitration 1961 11

Hague Convention on Civil Procedure 1954 11

New York Convention on Recognition and Enforcement of Foreign Arbitration Awards 1958 11

Universal Copyright Convention 18

Introduction

The transformation of the economies of central and eastern Europe is now well under way as democratically elected governments in each country attempt to correct the legal, political, environmental and economic distortions they have inherited.

The approach and pace of reform in each country has been different, largely due to the different economic, political, historical and social conditions prevailing in each country at the time economic transformation was initiated.

Hungary was better placed than most of the other countries in central and eastern Europe to commence the process of transition, having commenced its move away from a system of central planning as far back as the early 1960s. Hungary, at least, had the benefit of confronting transformation with a developed tradition of economic reform.

In an increasingly favourable investment environment, Hungary is continuing a process of introducing and maintaining a legislative framework designed to encourage private enterprise, attract foreign investment and know-how, and establish a competitive modern market economy.

The introduction of far reaching reforms has not, however, been achieved without economic hardship. Hungary has continued to experience economic dislocation as privatisation has developed and individuals and companies have adapted to the free market environment and the social cost of confronting political legacies is realised.

While Hungary comes to terms with the realities of freedom, and the free market forces to which its economy is now exposed, the international outlook for Hungary remains optimistic. The key legislative building blocks of a market economy are now in place. Since 1989 there have been major reforms of Hungary's company, taxation, banking, foreign investment, financial reporting, insolvency, property, employment and privatisation laws, and the association agreement Hungary entered into with the European Community (EC) was approved by the European Parliament in September 1992. In addition, the number of businesses operating in Hungary with foreign participation has increased dramatically in recent years.

This book is designed to provide existing foreign investors, and those contemplating an investment in Hungary for the first time, with a comprehensive overview of the Hungarian legal system, with particular reference to the commercial aspects of Hungarian law most likely to be encountered by the foreign investor.

The material contained in this book was prepared in late 1992 and early 1993 and is based on information and the legislation in force in Hungary as at 1 March 1993.

The contents of this text do not constitute legal advice and should not be regarded as a substitute for taking specific advice on particular issues.

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Table of Contents

	Glossary	viii
	Table of Legislation	x
	Introduction	xiii
1	**Hungary – a country and business profile**	
1.1	Geography and climate	1
1.2	History	1
1.3	Political and legal system	2
1.4	Population and social patterns	2
1.5	Economic and business climate	2
2	**Investment climate**	
2.1	Establishment of an economic association with foreign participation	5
2.2	Acquisition of real estate	5
2.3	Tax incentives	5
2.4	Repatriation of profits, capital and income	7
2.5	Protection of foreign investment	7
2.6	Regional incentives — duty free zones	8
2.7	Convertibility of the HUF	8
3	**Legal framework**	
3.1	The constitution	9
3.2	Parliament	9
3.3	Structure of government	9
3.4	The judicial system	10
4	**Regulatory environment**	
4.1	Competition law and policy	12
4.2	Exchange controls	15
4.3	Intellectual property	16
4.4	Regulatory aspects of environmental law	19
4.5	Concessions	21
4.6	Draft mining law	22
4.7	Telecommunications law	24
5	**Company law**	
5.1	Forms of investment vehicles	25
5.2	General provisions	25
5.3	Regulations applicable to all economic associations	26
5.4	Limited liability company (Kft)	28
5.5	Joint stock company (Rt)	31
5.6	Unlimited partnership (Kkt)	39
5.7	Limited partnership (Bt)	40
5.8	Trade association	40
5.9	Joint venture (Kv)	41
5.10	Representative, information and service offices	41

6	**Financial reporting and insolvency**	
6.1	Audit and accounting principles	44
6.2	Applicability	45
6.3	Accounting principles	45
6.4	Accounting practices	46
6.5	Reporting and book-keeping requirements	47
6.6	Consolidated accounts	48
6.7	Disclosure and publication	48
6.8	Auditing	49
6.9	Civil liability	49
6.10	National accounting board	50
6.11	Transitional provisions	50
6.12	Bankruptcy, liquidation and final settlement	50
6.13	Bankruptcy procedure	50
6.14	Liquidation	52
6.15	Final settlement	57
7	**Commercial law**	
7.1	Civil Code and law of contract	59
7.2	Liability and unjust enrichment	62
7.3	Security interests and guarantees	64
7.4	Law of agency	64
8	**Taxation system**	
8.1	Corporation tax	67
8.2	Personal income tax	71
8.3	Double taxation and withholding tax	72
8.4	Taxation procedures	72
9	**Property law**	
9.1	Legislative framework	73
9.2	Registration of title	73
9.3	Ownership	74
9.4	Dealings with real property	74
9.5	Mortgages	75
9.6	Leases	76
9.7	Usufruct	77
9.8	Servitudes	77
9.9	Pre-emptions	77
9.10	Options	78
9.11	Protection against expropriation	78
9.12	Real property taxes	78
10	**Banking and finance**	
10.1	The banking system	80
10.2	The stock exchange and trading in securities	83
10.3	Insurance	85
11	**Employment issues**	
11.1	Employment contracts	87
11.2	Labour relations	92
11.3	Compensation liability	94
11.4	Labour disputes	94
11.5	Foreign personnel	95

12 Foreign trade with Hungary
12.1 Import-export regulations 96
12.2 Customs procedures 97
12.3 Customs duties 99

13 Aid for encouraging trade
13.1 The EC PHARE programme 102
13.2 The Know-How Fund 103
13.3 The European Investment Bank 104
13.4 The European Bank for Reconstruction and Development 104
13.5 World Bank 105
13.6 Hungarian-American Enterprise Fund 106
13.7 Overseas Private Investment Corporation Programmes 106
13.8 US Trade and Development Programme 107
13.9 Environmental Enterprise Assistance Fund 107
13.10 General 108

14 Privatisation
14.1 Development of the privatisation programme 109
14.2 Role of the State Property Agency 110
14.3 Role of the State Property Management Corporation 112
14.4 Methods of privatisation 114
14.5 Mechanics of transformation 118
14.6 Special transformation issues 119
14.7 Privatisation issues 120

Index 122

1 Hungary – a country and business profile

1.1 Geography and climate

The Republic of Hungary (*Magyar Köztársaság*) is a country covering an area of approximately 93,000 sq km in central Europe. Geographically, the country lies at the heart of central Europe. Landlocked, with no access to its own seaport, Hungary shares common borders with Austria, Slovenia, Slovakia, Romania, Yugoslavia and the Ukraine.

Hungary is predominantly a flat, fertile plain divided approximately into thirds by the river Danube (Duna) and its tributary, the river Tisza. Almost 84 per cent of Hungarian territory is below 200m in height.

Hungary's climate is temperate but continental with four distinct seasons. Winters are characteristically cold and summers hot.

1.2 History

The Carpathian basin, in which Hungary is located, has been inhabited by a variety of ethnic groups since early times.

Hungarian history is generally seen as starting with the arrival of the Magyars from central Asia around 896AD, although parts of what is now Hungary were occupied by Celtic warriors as early as the third century BC.

Hungarian history is characterised by conquest, turmoil and uprisings. The Celts were followed by the legions of the Roman Empire, the Vandals, the Huns and the Avars in the Dark Ages, and the Mongol hoards in the thirteenth century.

In 1541 the independent Hungary ceased. The north and west part of the country fell to the Austrian Habsburg Empire, Central Hungary came under direct Turkish rule, whilst Transylvania, which was independent with regard to its domestic policy, was dependent on Turkey for its foreign policy.

In 1867, following a long period of resistance by the Hungarians, the Habsburg Empire was split into two dominions — the Empire of Austria and the Kingdom of Hungary. This left the Hungarians with control over substantial minorities, notably the Romanians, Slovaks and Croats.

Following defeat in World War I, the Austrian-Hungarian empire collapsed. Under the Treaty of Trianon in 1920 Hungary was forced to cede major parts of its territory to Romania (Transylvania) and to the newly created states of Czechoslovakia and Yugoslavia. As a result several million Hungarians were left outside the new Hungarian state. These frontiers still remain in force today.

Hungary entered World War II on the side of Germany and Italy. Soviet troops finally defeated the German forces occupying Hungary in April 1945.

In the years following World War II, living standards fell dramatically as the Soviets imposed a Stalinist programme of industrialisation and nationalisation, developing heavy industry but ignoring infrastructure, light industry and agriculture.

Social dissatisfaction with the political and economic situation led to the popular uprising in Hungary in October 1956. The Soviet Union invaded Hungary and after two weeks of fighting the Hungarians were suppressed.

János Kádár was given the task of restoring the communist regime by the Soviet leadership. After years of consolidation and reconstruction Kádár introduced the new economic mechanism in 1968 to decentralise control and management but without private ownership of production facilities, except for small scale agricultural production. The new economic mechanism did have some initial success and living standards in Hungary were considerably higher than those in many of the other communist countries of the region.

In the late 1980s, Hungary pioneered many new economic and political reforms facilitated by the new era of Soviet politics under President Gorbachev. In 1988 new tax reforms were introduced, the banking system was reorganised and steps were taken towards the liberalisation of wages and prices. These reforms were followed in 1989 by new company laws and laws on the reorganisation and privatisation of state-owned enterprises. The programme was further extended in 1990 by the establishment of the Budapest stock exchange.

1.3 Political and legal system

The Hungarian legal system is based on written laws as enacted in accordance with the constitution, which was adopted by parliament in 1949 and completely rewritten in 1989. Its most recent amendment was in 1990. Following the adoption of the new constitution, the communist party (named the Hungarian Socialist Workers Party) renamed itself the Hungarian Socialist Party and abandoned its claim to a leading role in the running of the country.

Under the terms of the constitution, Hungary is an independent state based on the rule of law dedicated to a multi-party system, parliamentary democracy and a social market economy. A major feature of the reforms in recent years has been the movement to replace government decrees by a series of primary statutes, openly discussed, amended and finally passed by parliament.

A variety of opposition groups and parties have now emerged in Hungary and multi-party elections were held in March and April 1990. The Hungarian Democratic Forum emerged as the winner and took power in coalition with the Christian Democrats and the Small Holders. The opposition is now formed by the Centre Left Free Democrats as well as the Young Democrats (FIDESZ) and the Hungarian Socialist Party. The next election will be held in 1994.

1.4 Population and social patterns

The population of Hungary was estimated in 1990 at approximately 10.3 million.

Approximately 97 per cent of the population is ethnically Hungarian and 59 per cent of the population live in cities. The largest cities (1990 estimates) are Budapest, the capital (2.1 million), Miskolc (214,000) in the north east of the country, Debrecen (211,000) in the east, Szeged (180,000) in the south, Pecs (177,000) in the south west and Gyor (131,000) in the west.

Women account for 50 per cent of the population. Hungary has an ageing population profile as the population is declining and average age is rising.

There are no large immigration or emigration trends, except for a recent influx of refugees from Romania. Many of these are ethnic Hungarians.

Approximately five per cent of the population of Hungary are national minorities. Most of these are Germans or Slovaks, but there are also Romanians, Serbs and Croats.

The principal language is Hungarian (*Magyar*). Typically, either German or English is used in business discussions involving foreigners.

1.5 Economic and business climate

Hungary's decision in 1989 to embark on a process of transformation to a fully developed market economy did not involve, as it did in other countries in central and eastern Europe, a total departure from Hungary's economic past.

Hungary began its move away from a centrally planned economy as far back as 1964. Reforms in the period leading up to 1989, which included the introduction of the new economic mechanism in 1968, encompassed the elimination of centrally planned targets, decentralisation of some decision-making responsibilities to enterprises, establishment of tax and company law systems and the introduction of a two-tier banking system.

Although the initial reforms did provide full employment and a marginal rise in wages and living standards, they did not result in lasting success and during the 1970s and 1980s Hungary became heavily indebted and a significantly poorer relative to the market economies of the organisation for economic cooperation and development.

Successive Hungarian governments have proved incapable of making a more decisive break with the past. The legacy of the 1956 Hungarian uprising, and the events in Czechoslovakia in 1968, created uncertainty about the extent of reform that would be tolerated by the Soviet authorities and Hungary's important trading partners at the time, being members of the Council for Mutual Economic Assistance (CMEA), did not share Hungary's enthusiasm for market orientated reform. In addition, there was limited scope within Hungary for private ownership and a lack of information and incentives which affected decision making at all levels.

The economic reforms introduced in Hungary since 1989 have gradually implemented and extended the scope of previously initiated policies. As a result, private sector and joint venture activity has increased considerably and Hungary has demonstrated an ability to redirect its exports and imports away from CMEA markets to the markets of advanced industrialised countries and continue to service its convertible currency debt.

Rapid liberalisation of prices has resulted in approximately 90 per cent of retail sales now being made at market value. Price liberalisation, deregulation of imports, cutbacks in subsidies and budgetary and financial reporting reforms, have all contributed to a more transparent environment for the making of macroeconomic and microeconomic decisions.

Despite recent reforms, gross domestic product is expected to continue to decline, inflation has continued to increase (although in 1992 a considerable decrease in the inflation rate has taken place) and the burden of foreign debt remains heavy.

One of the major obstacles to further internal progress has been Hungary's undeveloped banking system which, prior to the 1987 banking reforms, tended to allocate resources to ailing state-owned enterprises in preference to new projects helping to sustain inflationary pressures and giving rise to Hungary's current debilitating domestic interest rates. Further reform of the banking sector is required to increase the efficiency of state industries, reduce inflation and release capital for new investment.

The programme for privatisation of Hungary's commercial banks has commenced and the government has indicated that privatisation will take place as soon as bad and doubtful debts inherited from the pre-reform era are either recognised, written off or provided against by the commercial banks. Current estimates of the level of non-performance in the loan books of Hungary's commercial banks range from 15–30 per cent. Recapitalisation of many of the banks will be required before privatisation can occur.

The liberalisation of price controls and further banking reforms are likely to result in a substantial decline in real incomes and a drastic increase in unemployment as old state industries are forced to either reorganise their operations to compete or face liquidation under Hungary's new financial reporting and insolvency legislation. More than 300 of Hungary's major state industries are reported to be on the verge of bankruptcy.

Liquidation of inefficient and insolvent industries will not only reduce gross domestic product but will also result in the loss of important trading markets and impact on the cost to the nation of its social security system. Demands for increased social security expenditure and further tax reforms to stimulate the economy will make it extremely difficult for the government to prevent further expansion of the budget deficit.

The privatisation programme in Hungary, perhaps the key economic reform, has been based on the sale of assets, rather than on systems of distribution of assets through vouchers or the restitution of assets to original owners, which have been favoured by certain other central and eastern European countries. At the time of preparation of this manuscript, the introduction of property tickets worth one million Hungarian forints (HUF) due to every citizen as a matter of right is under consideration by the government.

A comprehensive legal framework for the establishment of new private industry and the transformation of state-owned enterprises and cooperatives into economic associations has now been established, although delays and reassessment of the methods of implementation, especially concerning the valuation of state property, have resulted in large and medium scale privatisation only now beginning on the scale expected.

A range of techniques have been developed for the sale of state assets and privatisation can now be initiated not only by the State Property Agency (SPA), but also by enterprises themselves and outside investors. Hungary has been particularly successful in attracting foreign investment which has served to