Chapter-III

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Market economy with its far-reaching division of labour and highly complex coordination tasks can not function properly in the absence of a clear and transparent legal enactment as well as institutional framework for the adjudication and enforcement of legal provisions. The transformation from state socialism to a market economy could be achieved only with the fundamental reshaping of the existing legal regime. Hungary and Poland have undergone a series of legal and institutional changes from time to time to pave the way for a market economy and to make it more investor friendly to attract foreign capital.

It is evident that some limited foreign capital was involved even in the socialist years. Therefore, the use of foreign capital and private property in Hungary and Poland did not start from zero. However, Hungary and Poland’s move towards market economy and to use the foreign capital for macro-economic reasons involves an unprecedented attempt in transferring the ownership of almost 90 per cent of its economy from the state control to the private management. The development of a legal regime certainly facilitates private transactions and the inflow of foreign capital into different

sectors of the economy. Development of market friendly environment was essential to carry forward the process of transition to a market economy. Therefore, legal legislation or otherwise called as institutional changes was necessary in different fields. Significant among them were Company anti-monopoly Contract, Bankruptcy Laws, Foreign Investment Laws and financial sector reforms.

The adoption of clear laws and safeguards for various ownership categories, changes in the behaviour of enterprises, the introduction and use of market mechanisms, infrastructures and price reforms were the necessary preconditions for the efficient functioning of market system. Several institutional changes have, therefore, taken place in both Hungary and Poland from time to time to attract the attention of investors so as to push their respective economies to be driven by market forces than any other consideration.

The process of legal and institutional change to effect the transition from a state-controlled economic system to a market driven economy in the Central and East European regions, particularly Hungary and Poland are discussed in two separate sections.

**Section-I**

*Hungary*

**New Management System (1984)**

With the New Management System or the Enterprise Act (1984), a form of self-management i.e., enterprise or workers' council was introduced into the majority of state
owned enterprises (SOEs). It was aimed at providing autonomy to enterprises. Earlier it
was under the direct control of the State. The system of socialist economy was
vehemently objected by the policy makers and the reformers keeping in view the
inefficient nature of the state owned firm, low level of production, low supply and a
decreasing growth of output. This Act, in effect, transferred a considerable degree of
control over enterprise assets and the exercise of certain ownership rights to the
enterprise themselves. The Act affected nearly 70 per cent of SOEs, giving them decision
making powers over restructuring, merges and de-merges, the right to set up joint
ventures, etc., and the remaining 30 per cent enterprises were mainly in strategic sectors
which were placed under the supervision of Branch Ministers.

The Bankruptcy Law (1986)

The Bankruptcy Law was enacted to regularise the process of closing of a firm or
declaring it bankrupt.\textsuperscript{50} This made it possible for every management unit to have contact
with the state and co-operative firms or incorporated small enterprises to initiate
bankruptcy procedure. It also created a way for the management\textsuperscript{1} of the units to ask the
courts for their own elimination. Prior to the Bankruptcy law, the firms, though
inefficient in so far as covering the costs were patronised by the state under the syndrome
of soft budget constraint.\textsuperscript{51} Hence, this law was expected to harden the financial
discipline for the enterprises and the exit barrier for the inefficient units and so also to
defend the interests of creditors.

\textsuperscript{50} Privinfo, 1995, p. 14.

\textsuperscript{51} Janos Kornai, Economics of Shortage (Amsterdam: 1980), p. 306.
New Bankruptcy Law

Under the new Bankruptcy Law of 1991, a firm is known as bankrupt if the same firm is default of any debts for more than 90 days. It provides two alternative procedures, reorganisation and liquidation. The number of bankrupt firms has increased from 528 in 1991 to 14,300 (4400 as reorganisation and 9900 as liquidation) in 1992.\textsuperscript{52}

The New Company Act (1989)

The New Company Act came into effect in January 1989. It recognised the unlimited partnership, the Limited Liability Company (LLC) and the Company Limited by Shares (Co. Ltd.). This Act is considered to be very important for the economies in transition in general and Hungary in particular as it encouraged entrepreneurship by reducing investors risk. Hungarian law permitted only unlimited liability companies, which were risky particularly in a planned economy.

The main purpose of the Act was to promote the free flow of foreign capital into the region and thereby creating a competitive environment into what had been stagnant under the state monopoly markets. Accordingly, the Act permitted economic associations to acquire property, enter into contracts and sue in court to enforce their rights.\textsuperscript{53} The Act

\textsuperscript{52} Privinfo, n. 2, p.15.
also encouraged freedom of contract by allowing many structural aspects of partnerships and co-operation to be determined by privately negotiated deeds of association. Generally, the Company Act geared towards creating and re-integrating small-scale enterprises back into the national economy. The preamble emphasised that the benefits of citizen’s ability to find business associations and de-emphasises the Act’s application to large concerns. It declared that “in order to maintain the stability of our economy it would not be purposeful to transform (self-managed enterprises) into the new forms of associations.”

The Foreign Investment Act or Foreign investment Code (1989)

The Foreign Investment Act was the first liberal legislation of its kind in Eastern Europe. Under this law foreign investors were guaranteed full compensation in the currency of original investment. Act XXIV of 1989 on foreign investment in Hungary was one of the most comprehensive pieces of Hungarian legislation to protect foreign investments. The code was made inseparable from the accompanying Act on Business Associations that was pivotal in providing organisational forms for foreign investors. These Acts allow foreign individual or corporations to own 100 per cent of an enterprise including the real estate. Moreover the investor does not need governmental approval to acquire such ownership.

54 Ibid.
56 Ibid.
The Transformation Act (1989)

In response to the abusive privatisation that occurred under the Company Act and Foreign Investment Act, the Hungarian parliament passed the Transformation Act in May 1989 which took effect on July 1 of that year. This legislation regulates the transformation of state owned enterprises into the corporate forms that was introduced by the Company Act. One of the most important objectives of the Transformation Act was to confer legal succession to the transformed economic entity. It also allowed the sale of stocks to other corporations and commercial banks and joint venture with foreign firms. According to this law stock ownership determines the control of the company. A self-managed enterprise can transform itself by a two-third-majority vote of the governing body. It must then send a proposal or notification to the SPA for approval. The proposal must include (a) the economic objective of the transformation, (b) the names of interested external entrepreneurs and the extent of any preliminary dealings and (c) balance sheets of the enterprise. The enterprise may not enter into any binding legal commitments without the approval of SPA. The SPA has thirty days after receiving the proposal to act and a further thirty days is allowed as extension. If the SPA approves, it has to specify the terms of transformation. If the SPA fails to act in time the enterprise can proceed with the transformation and set its own term, though it must provide the SPA a copy of its plan as well as the book balance and the property balance. The transformation becomes final when SPA signs the contract of association. The SPA has the authority to refuse to sign if

the contract does not comply with the terms set forth in the transformation planner and also if the SPA deems a revaluation of the assets to be necessary.58

With the transformation process being widely acclaimed among the policy makers, it was instrumental in attracting the inflow of foreign direct investment into the region, particularly to Hungary. The Act played an important role as a strong confidence-building measure to promote the interest of the investors.

The State Property Agency (SPA)

The State Property Agency was created to facilitate and oversee the spontaneous privatisation process.59 Draft legislation of SPA and the management of state assets for the privatisation of retail catering and consumer services outlets was ready in November 1989 bearing the title “Ownership Reform and Privatisation Programme”. The new body came into effect on March 1, 1990 as the title of State Property Agency under the chairmanship of Istvan Tompe,60 who had been the privatisation commissioner.61 The number of state-owned enterprises intended for transformation and privatisation under the management of the SPA was 2200. The total book value of their assets was estimated at over 2000 billion HUF. Three per cent of these enterprises were founded by ministries and 37 per cent by municipalities. 32 per cent were under state administration and 56 per cent under self-management, while the remaining 12 per cent had been transformed into companies on 100 per cent state ownership.

58 Ibid.
60 Ibid.
61 Ibid.
In July 1990, the SPA was modified in the sense that it was removed from parliamentary control and placed under the direct authority of the government. The scope of its powers was extended and the possibilities of appealing against its decision through the courts were abolished.

The First Privatisation Programme (FPP)

The SPA’s first privatisation programme of September 1990 was the first formally organised attempt by the Hungarian government to privatise systematically its most profitable industries. The programme involving 20 large and reasonable enterprises covered a wide range of activities. The combined turnover of these enterprises totalled HUF 100 billion, and their book value was estimated at HUF 70 billion. The programme was spectacular in its scope and its aim was to attract as much investment as possible from foreign investors and from the public support within the country itself. Over 300 firms including some of world’s top investment banks tendered proposals for the valuation and transformation contracts for the enterprises in question. But despite this initial interest the programme had been unsuccessful. By October 1991, only four of the enterprises had been corporatised and although by the end of 1992 this number had increased to 18 out of original 20, only 3 of the firms had been fully privatised.

The Second Privatisation Programme (SPP)

The second privatisation programme was launched in March 1991. Its aim was to tackle the problem of the ‘empty shell’, i.e., the state holding companies. The void

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62 Ibid.
caused in the first privatisation programme had to be rigorously addressed in the second plan. Those enterprises that have already drawn up transformation plan were included in the second attempt. However, the second privatisation programme was not comprehensive enough to cover up the void caused during the first privatisation programme. Many of the enterprises were not even touched upon by the programme; as a result of which the participation of foreign investors in the process of bringing foreign capital into the region was not upto the desired level.

Investor Initiated Privatisation

In the hope of accelerating privatisation, the SPA formulated a programme of Investor Initiated Privatisation in February 1991.\(^\text{64}\) It aimed at allowing the investors to lead the process. The initial interest on this programme was widespread, with almost 250 offers registered in the first few months mainly from foreign investors and covering a wide range of packages ranging from a few shares to entire enterprises. But the overall progress remained slow. The SPA attempted to complete the process by calling open or closed tender from foreign investors. Such measures imply that the policy makers were in the threshold of providing plenty of actions to be taken by the foreign investors in a bid to create a conducive atmosphere for the foreign investors. Despite all these uncertainties regarding a clear picture on the ownership rights of private property, the inflow of foreign direct investment into the region was quite satisfactory and the trend of foreign capital flow was positive for the next three consecutive years.\(^\text{65}\)


Institutional Ownership and Management of Corporate Assets

In Hungary there were various kinds of institutional ownership of assets developed in state hands. The first and most obvious case was that of local municipalities to which the transfer of assets worth an estimated HUF 3000 billion was completed. The process began with law on municipalities passed at the end of September 1990, which transferred the ownership rights to the new local authorities. The real estate was earlier under the control of councils with the exception of historical monuments and ecological reserves. The second stage of legislation paved the way for the transfer of assets to the municipalities. The public housing stock and non-residential premises were transformed to the new local authorities along with local public services such as water, drainage, sweeping, burial services, estate management, street cleaning and garbage removal etc.

The Social Security Services

The social security services also received a substantial portion of assets through two separate processes. In July 1992 the government of Hungary pledged the transfer of assets worth HUF 300 billion to the social security services and that was mostly in the form of shares in companies in portfolio of the SPA and the State Asset Management Company (SAMCO). However the function of this programme could not gather

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66 Anna Canning and others, n. 16, p. 20.
67 Ibid.
68 Ibid.
momentum in its initial period but later, in the year 1993, stress was emphasised to augment the function of crisis sector.

The Treasury Property Management Organisation

The Finance Ministry set up the Treasury Property Management Organisation in 1990 to manage property formerly used by the Soviet Army, by Communist political organisation and the disbanded workers’ militia. The government issued regulations governing the use and sale of properties vacated as a result of withdrawal of Soviet Armed forces, but unfortunately it got little success.

State Asset Management Company (SAMCO)

State Asset Management Company was set up in 1992. The notion of setting up such a body was first aimed in the spring of 1991 by the Hungarian finance minister Mihaly Kupa in a draft bill on transformation process supplementing his four years of economic reform. The finance minister came under attack from many sections of people suspecting him of attempting to bring the privatisation programme under his control and thereby concentrating power. After a period of uncomfortable silence on the issue of enterprise restructuring, the finance minister finally published its draft. The preamble of that document stated that “enterprise restructuring can not be based on centralised considerations..... the power base of the state supervisory system set up concrete

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70 Ibid.
proposals for a body which would separate institutionally the task of exercising state ownership and that of executing the process of restructure.\textsuperscript{71}

Employee Share Ownership Programme (ESOPs)

Provisions were made for 'employee shares ownership' in the company law and a basic regulatory framework set out in the original (1990) property policy guidelines. It mentioned that up to 10 per cent and in exceptional cases up to 15 per cent of enterprise assets were to be offered at preferential prices in an experimental basis. Legislation on ESOPs was passed by Parliament in June 1992.\textsuperscript{72} The number of firms taking this option was not initially impressive. But later by the end of 1993 it was increasingly popular and some degree of employee ownership appeared to be involved in around half of the cases of enterprises privatised under the self-privatisation scheme alone, and the proportional share owned by employees has increased substantially.

Privatisation by Leasing

The leasing measure aimed at countering the lack of domestic capital for enterprise restructure and to provide some support to the investors. The basic principles of leasing measures are as follows:

(a) a majority (up to 100 per cent) stake in the company is transferred by the SPA to the lessee, who was then entitled to exercise all rights over the firm except the

\textsuperscript{71}Quoted in Anna Canning and Paul Hare, n. 16.
\textsuperscript{72} Anna Canning and others, n. 16, p. 25.
right to sell or transfer ownership of the assets.\textsuperscript{73} The SPA remains the owner until the end of leasing contract or until such time as the leasing fee has been paid in full.

(b) Lessee must agree to maintain the value of the assets under their control and may not pay out dividends for the duration of contract. However, the process of setting up the leasing mechanism was still not matured as it was expected to be.

Reform in Banking Sector

From early 1987, Hungarian authorities reorganised the banking system and launched a two tier banking system. Under the new banking system the tasks of the Central Bank were distributed among commercial banks. Apart from this many specialised financial institutions, development institutions, banks with foreign participation and the saving banks were established. Banks could also help in finding suitable investors as well as making deals acceptable to investors. But the role banks can play in loans depends partly on the decisions concerning ‘bad loans’.

Security and Stock Market

Budapest Security Market was established in 1983. The bonds issued before 1989 were securities bearing fixed interest rates but inflation in later years compelled investors to turn towards treasury bonds, issued by the state and valid for three, six and nine months and deposit certificates issued by banks for 1-3 years. In fact the security market was built mainly on banks and financial institutions. The Budapest stock exchange was

\textsuperscript{73} Ibid.
formally opened in June 1990\textsuperscript{74} and 42 banks and stock market institutions signed the establishment chapter. Hungary's experience of the restructuring programme was not much of positive trend but the economy could muster enough foreign investments in the awake of a series of reform process undertaken by the policymakers.

**Investment Related Measures: Recent Changes**

Hungary's ability to attract Foreign Direct Investment (FDI) has been impressive: because it has the largest inflow of FDI in the region, attracting 40 per cent of the total FDI in Central and Eastern Europe. The total amount of FDI reached approximately 13.3 billion USD for the period 1990-1996. This has helped to reduce the foreign debt whilst contributing positively to the restructuring, privatisation and modernisation of Hungarian industry. Capital inflows, in addition to FDI, have been significant, as the long term government securities market is open to foreign investors, and the HUF yields are sufficiently attractive to induce portfolio investment flows. Substantial private sector borrowing has also contributed to the net inflow of capital. These developments have been, in part, due to Hungary's liberalised policies concerning the free movement of capital.

At present foreign companies are more inclined and the policies of the government has been designed to attract multinational companies (MNEs) to establish branches in Hungary. However, preparatory work of corresponding legislation that had begun way back in early 1990s have started taking shape and amendments were made in

\textsuperscript{74} Anna Canning and others, n. 16, p. 26.
different sectors to make it accessible for the inflow of foreign capital. Company law is largely regulated by the Company Act of 1988. A number of different types of entities are recognised under Hungarian law, including companies limited by shares and limited liability companies. As on 30 April 1996 there were over 94,000 registered companies. Companies may issue shares and there are provisions for the protection of shareholders in that event. Minimum capital requirements are laid down by law and there are provisions equivalent to the protection of authorised capital. Creditors also enjoy a certain level of protection. A Register of Companies is maintained at the Court of Registration, which contains the basic information about each company. There is in addition a computer database making the information on a public company data widely available.

Foreign exchange measures under the exchange rate regime established at the beginning of the transition process, the forint was pegged to a basket of currencies: initially 50/50 to the USD and the DEM respectively and since May 1994 to the USD (3 per cent) and the ECU (70 per cent). The exchange rate fluctuation band was increased from 1.25 per cent to 2.25 per cent in December 1994. The pre-announced crawling peg was installed in March 1995 and, after having been set up at 1.9 per cent per month until June 1995 and at 1.3 per cent for the remainder of 1995, it is 1.2 per cent per month since January 1996.

Currency Convertibility

In the beginning of the transition process, Hungary introduced currency convertibility for most foreign trade transactions except for tourism purposes for

residents. The new Foreign Exchange Law, passed in November 1995 and effected since January 1996, establishes full current convertibility and liberalises some capital transactions. The central bank operates a "crawling peg" exchange rate policy, whereby the forint is devalued each month by a fixed, pre-announced rate against a basket of currencies.

The most important changes were the removal of restrictions on outward direct investment, personal capital movements and granting of trade credits. Further relaxation of restrictions on portfolio investment by residents abroad were introduced from 1 July 1996. From 1 January 1997 the acquisition by residents of shares and bonds of OECD based enterprises with investment grade rating was liberalised. The underlying principle for further capital liberalisation remains the same as that followed so far: first, transactions with longer maturities and then transactions with shorter maturities. Based on the above principles, the further opening of the capital account was planned as follows:

- After January 1, 1998, the establishment of branches of foreign companies in all sectors was allowed.

- Within 1 to 2 years, medium and long-term capital transactions got to be liberalised.

76 A method of controlling exchange rates. This is a general term applying to any proposal with the characteristic that Par Values – the official exchange rate as declared by the International Monetary Fund – can be adjusted over time. The required change being split into much smaller parts which are spread over a certain period. Thus a revaluation of say 10 per cent might be achieved by successive changes of two per cent. The advantage is that the change can be offset by a change in the domestic interest rate thereby reducing the possibility of speculation having a destabilising influence. This is also known as sliding parity.

However, further efforts are still required, though, especially in liberalising outward capital movements and removing investment restrictions on institutional investors\(^{78}\) (e.g. insurance companies).

**Bilateral Relationship with the United States**

Bilateral relations between the United States and Hungary continue to expand and strengthen. As early as 1989, the U.S. Government designated Hungary as eligible for various economic assistance programs as well as a recipient of trade preferences. The United States supports Hungary's desire to integrate itself into the western political, economic and security institutions. For example, the United States strongly encourages Hungary's entry into the OECD, and into the European Union. The United States has been a major proponent of Partnership for Peace (PFP) which establishes a relationship between countries in the region and NATO. Hungary in turn has endorsed PFP.

**Social Enactment**

On 12 March 1990, the Hungarian Government introduced measures to curb the growing state budget deficit. Among the measures taken were curtailing maternity support, instituting a token tuition system for universities, and an import surcharge. The net effect may mean a dampening of consumer spending in some segments of the population. Consumer spending is also being pinched by price rationalisations in electricity (up 71 per cent), natural gas (up 56 per cent), gasoline (up 30 per cent) as well as higher telephone rates (increased 10.2 per cent).\(^{79}\)

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\(^{78}\) See n. 28.

\(^{79}\) [http://www.ebrd.org](http://www.ebrd.org)
Joint Ventures/Licensing

The term "joint venture" is used in Hungary to refer to any venture, which involves foreign participation. In the broadest sense, American business strengths combined with Hungarian assets can create a powerful business operation. However, U.S. partners need to gauge all aspects of such a business relationship such as a lingering legacy of inefficiencies. Some ventures can become mired in the partner's old-style of management or in a passive resignation to bureaucracy. Where the operation is still in state hands, a forthcoming privatisation may pose concerns or disruptions for the JV. Promoting an efficient workforce or taking hard decisions on employment levels requires continuity and shared goals on behalf of all parties in the management. The time and effort in achieving these goals can be substantial and should be weighed against such alternative business options as a contractual relationship, the privatisation of the target partner, or a Greenfield operation. Needless to say a good working relationship with the local partner prior to moving into a joint-venture, along with a strong local legal counsel are keys to a successful joint-venture.

“In establishing a joint venture, the following information must be submitted to the local Court of Registration: name, headquarters, initial capitalisation, members and shares, and the articles of association (deed of foundation for single person companies). A Hungarian attorney must countersign the articles of association. The founding of the company must be reported to the court within 30 days. Following submission of the information, the court will act on the submission within 60 days. If this period has

expired without the foundation being challenged by the court, registration of the company is assumed approved. The registration fee charged is 2 per cent of the initial capital or a maximum HUF 90,000. Pursuant to the law, the company is required to announce its creation in an official gazette.\textsuperscript{81}

\textbf{Trade Relations and Standards: Trade Barriers}

In general, Hungarian import policies have progressively liberalised in an effort to encourage competition and to allow imports of materials necessary for Hungary's economic transformation. As part of its Uruguay Round implementation on January 1, 1995, Hungary raised tariffs on other agricultural products to WTO levels.\textsuperscript{82} As a result, it has affected U.S. exporters and investors on such products as sugar, rice, peanuts, confectionery products, chocolate, and soft drink concentrates. At the same time, the Hungarian Government established minimum access quotas that allow certain volumes of goods to enter the country at a lower tariff rate.

In an effort to arrest a high and growing current account deficit, the Government of Hungary introduced an 8 per cent import surcharge in March of 1995 on all imports except energy and inputs for investments. This surcharge was expected to stay in place until mid-1997. The rate of that surcharge started decreasing from early 1997. While Hungary's average tariff rates are decreasing, there are particular peak rates which are still unduly high.

\textsuperscript{81} http://www.tradereport.org/ls/countries/hungary/climate.html
\textsuperscript{82} Ibid.

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Free Trade Zones/Warehouses

Companies operating in one of Hungary's free trade zones are exempted from customs and foreign-exchange requirements of the country as well as from indirect taxation tied to the turnover of goods. With respect to direct taxes (profit taxes, company taxes, etc.), the companies enjoy transitory preferences. Customs-free zones could be established anywhere in the country provided requirements of the Customs authorities are met.83

Membership in Free Trade Arrangements

In December 1991, Hungary signed an Association Agreement with the European Union (EU) which has phase out tariffs over an extended period of time. The agreement immediately removed EU duties on 70 per cent of Hungary's industrial exports to the EU, and lifted quotas on 60 per cent of its total exports. Trade in textiles, steel, coal and farm products would be eased over several years. In June 1993, the EU agreed to accelerate the agreement's provisions and reaffirmed its commitment to Hungary's full-membership.84

In December 1992, the Czech Republic, Hungary and Poland negotiated a Central European Free Trade Area (CEFTA). Modelled after the structure of the EU association accords, this agreement reduces trade barriers over an 8-year period; duties on 15-30 per cent of mutual trade were eliminated immediately upon implementation of the Agreement

84 Ibid, p. 23.
in March 1993. A supplementary agreement, signed on June 18, 1994, accelerated the agreement's provisions.

Finally, Hungary concluded a free trade agreement with the European Free Trade Association (EFTA) countries in July 1993. Again, this agreement was modelled after the EU accords and will eliminate trade barriers for Hungarian goods entering the EFTA countries by 1997 and for EFTA imports by 2001. EFTA accounts for nearly 15 per cent of Hungary's total trade. Hungary is negotiating with the EU to ensure that Hungary does not lose any benefits as a result of EFTA countries joining the EU.

In April 1994, Hungary and Slovenia signed a Free Trade Agreement which calls for a phased elimination of duty on industrial goods by 2001 and an immediate 50 per cent reduction of duty on certain categories of agricultural products.

**Openness to Foreign Investment**

Hungary has attracted over $8 billion in foreign direct investment, which is more than half of all foreign investment in Central and Eastern Europe. American investment leads the way in Hungary with nearly $4 billion. The current environment in Hungary encourages foreign investment and participation in virtually all spheres of the Hungarian economy.

Foreign investment may take any one of four forms: setting up a joint venture in existing businesses, obtaining equity in a state enterprise through privatisation,

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85 Ibid.
establishing a new (Greenfield)\textsuperscript{86} business venture, and making a portfolio investment. Hungarian Parliament has passed a number of laws intended to facilitate foreign investment. Four laws are of particular importance: the Companies Act, the Investment Act, the 1995 Law on Privatisation, and the Concessions Act.

Foreign investment in Hungary most often takes the form of a limited liability company. Other commonly used forms are companies limited by shares (joint stock companies), joint enterprises, business associations, general partnerships, limited partnerships, and sole proprietorships. Current Hungarian legislation makes no provision for branch operations. However, Hungary's agreement with the EU calls for legal regulations permitting such operations to be in place in five years.

Act XXIV of 1988 (as amended) on Investments of Foreigners in Hungary (the "Investment Act")\textsuperscript{87}, which sets forth the rules on the establishment and operations of companies with foreign participation, grants significant rights and benefits to foreign investors. It guarantees national treatment for foreign investments and abolishes the old requirement for government approval of majority or 100 per cent foreign-owned investments as well as providing protection against losses resulting from nationalisation, expropriation, or similar measures. The Investment Act guarantees free repatriation of invested capital and dividends.

\textsuperscript{86} Foreign investment can take two forms. The first is called foreign direct investment. Here, usually a Western company invests directly in local company or starts a new enterprise. This act of starting a new enterprise is called Greenfield investment. See Gerhard Pohl and others, "Creating capital markets in Central and Eastern Europe", \textit{World Bank Technical Paper}, no. 295, 1995, p.17.

\textsuperscript{87} Francis A Gabor, n.7, p. 297.
Act XVI of 1991 on concessions authorises the state to provide investors with concessions in return for their investment in infrastructure development and certain other sectors. Under the provisions of this act, private investors may have a partial monopoly in activities normally reserved for the central and/or local governments such as the construction of roads, railways and airports, power generation and transmission, mining, and operating games of chance. Concessions are normally awarded on the basis of a tender and include a time limit and a renewal limit (generally, 50 per cent of the original period). 100 per cent foreign ownership is permitted in sectors open to private investment. The exceptions to foreign investment are in defence-related industries, the media, and on foreigners' acquisition of land. Under the Land Law (Act I of 1989) and related regulations, foreigners may acquire agricultural land in some instances, such as in compensation for a prior expropriation. Foreign owned companies that are Hungarian legal entities might acquire real estate (with the exception of agricultural land) without restrictions. Foreigners, however, must make payments in hard currency. Under the Investment Act, these requirements do not apply to companies incorporated in Hungary, even if 100 per cent foreign-owned. Such companies, however, may only acquire real estate required for its economic activities. The new Land Law (Act LV of 1994) deals primarily with agricultural land, restricting the purchase of land by foreigners to 6,000 square meters, but allows for leases up to ten years for up to 300 hectares. Act LV prohibits businesses from purchasing arable land, though they may lease specified amounts. The land-ownership prohibitions on foreigners and businesses are seen as temporary and may be lifted when the real estate market reflects accurate land values.

As mentioned earlier, the Investment Act abolished the old requirement for government approval of majority foreign-owned investments. There remain two instances where screening is required: investments in financial institutions and insurance. "Acts LXIX of 1991 and CXII of 1993 on Financial Institutions stipulate that government approval must be obtained for the establishment of a financial institution owned fully or partly by foreigners as well as for participation by foreigners in a financial institution registered in Hungary. Such approval is not needed if total foreign participation in an institution will be less than ten per cent of its registered capital. The law sets out the necessary criteria, which include whether the applicant has the necessary capital, its business reputation and five-year track record, plans for training employees, and contribution to competition among similar institutions. Similarly, government approval is also required for foreign investments in insurance companies if the foreign share exceeds ten per cent of the company's capital."^89

The Corporate Tax Act was amended by Act IC of 1993, which withdrew automatic tax holidays for new investments as of January 1, 1994. However, companies that qualified for tax abatements prior to the deadline retain some of these benefits. In place of the tax holidays, the Hungarian Parliament introduced a discretionary new general tax reduction scheme effective from January 1, 1994. The new incentive is available in the form of a tax reduction based on a percentage of future taxes to be paid. Other conditions that determine eligibility are the amount of share capital, production if any, of environmentally friendly products, anticipated exports etc.

^89 http://www.tradereport.org/ts/countries/hungary/climate.html
The Act on Separate State Funds (Act LXXXIII of 1992)\textsuperscript{90} established an Investment Promotion Fund to encourage foreign investment in infrastructure, new technologies and public utilities. To qualify for subsidies from this fund, a company must have more than HUF 50 million ($500,000) in registered capital or capital stock. Not less than 30 per cent foreign ownership and the foreign contribution must be in convertible currency and not less than 50 per cent of the foreign partner's share. The third criterion may be waived if the technology is considered "environmentally superior" or "of technical excellence". This Act was modified on March 1995 at which time its name was changed to Economic Development Fund. It is now available for all investors, foreign or Hungarian.

Two import policies/practices that affect foreign investors exclusively are the Investment Law's provision for the duty-free import of capital goods by joint ventures. The second policy is the establishment of semi-annual quotas for automobile imports. For 1994, the number of automobile import licenses was limited to 96,000 (51,000 new, 30,000 used; with 53 per cent of each category imported from the EU and the remainder from outside the EU). These quotas are meant to protect the markets of domestic automobile manufacturers, all of which are foreign-owned companies. Imports used for investment purposes are not subject to the 8 per cent import surcharge introduced in March 1995.

While the policies pursued so far in Hungary's transition to a market economy have had much positive results, it is clear that much remains to be done. The momentum of structural reform needs to be sustained. It is important in its own right and the ultimate

\textsuperscript{90} \url{http://www.tradereport.org/us/countries/hungary/qfipmate.html}
success of stabilisation policies depends on continued progress with this kind of reform. Ambiguous legal enactment needs to be made more transparent and investor friendly so as to attract the attention of the western investors.

Section-II:

Poland

As it is mentioned earlier that adequate legal changes are the necessary precondition for the establishment of a market economy. Poland necessitates a thorough change in its structure in order to make it investor friendly. Poland has taken several measures like Hungary to swim with the current of market economy.

Tax Reforms

In line with the transition from a centrally planned economy to market economy the changes in the revenue instruments were of prime importance. The earlier revenue instruments were ill suited to the intended market economy. Poland, therefore, made a complete overhaul of its tax system during 1990-93.

In so far as the fiscal revamp in the Polish economy is concerned four major reforms\(^{91}\) can be cited. First, a uniform tax rate of 40 per cent on enterprise income tax (EIT)\(^{92}\) was introduced in 1989. Second, a 2 per cent tax on the gross payroll of


\(^{92}\) In January 1989, a uniform tax on income of legal entities (enterprises), independent of whether the entity is in the private or public sector, was introduced. The general statutory tax rate is flat and non-discriminatory 40 per cent levied on the tax base. The EIT replaced profit taxes that amounted to 65 per cent for the State sector and 85 per cent for the private sector. For more see Gerd Schwartz, n. 42, p. 18.
enterprises to finance the newly established unemployment insurance scheme was introduced in 1990 and that the scheme had to be administered by the Labour Fund. Thirdly, the introduction in 1992 of personal income taxation under personal income taxation (PIT)\(^93\) with the highest marginal rate being equal to the EIT. Fourthly, the introduction, in 1993, of a value-added taxes (VAT) at standard rate of 22 per cent and a reduced rate of 7 per cent. The introduction of the EIT, pay roll taxes for the labour fund, the PIT, and the VAT provided for more equitable taxation of income and consumption.

Prior to the transition most citizens were unaware of the existence of the taxes such as the introduction of the EIT and VAT. More than anything else the introduction of the above taxes sharpened public awareness of taxation issues and propelled tax policy to a centre stage in public policy discussion. Apart from the above policy changes numerous adjustments were necessitated for the smooth function of the fiscal system.

While the PIT, EIT and VAT were the centrepieces of tax reforms there were other revenue items that underwent fundamental reforms as well. The system of custom duties was revised. The factor behind theses changes can be traced back to the transitory association agreement of Poland with the European Union (EU). At the end of 1992, Poland introduced a temporary import surcharge of 6 per cent on import turnover. Though the surcharge was primarily introduced for balance of payment reasons it helped to ease fiscal constraints during the transition. Enforcement capacities were increased by changes in the organisational structure. The most important organisational change was

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\(^{93}\) See Gerd Schwartz, n. 42, p. 18.
the creation of a fiscal control inspectorate (fiscal police). The customs administration got integrated into the Ministry of Finance.

Expenditure Reforms

Major progress has been made with reducing subsidies to enterprises and consumers. With the liberalisation of enterprises of prices in 1990, it was no longer feasible to provide extensive subsidies on goods and services. However, the Polish authorities moved quickly to address this problem. Several subsidies were phased out at the outset of reform in 1990— for example, the budgetary subsidies to state farms. Sometimes, however, direct subsidies were replaced by other mechanisms, as for example, price stabilisation measures and other market intervention by the Agency for Agricultural Markets (ARR) that was set up in June 1990. Many expenditure adjustments were aimed at containing cash outlays in the face of growing budgetary pressures. Therefore, some allowance like the family allowances were suspended for the time being but later this suspension was revoked in the Constitutional Tribunal in 1992. Again in January 1993, owing to budgetary pressures the pension formula and so also the family allowance defined the actual pension base.

Reforming Expenditure Management

Changes in expenditure management during the transition were largely motivated by the need to restrain the fiscal deficit to manageable levels. Therefore, the transition period saw a stronger reliance on cash rationing as a main tool of expenditure...
management. There were two early legal changes that provided expenditure management with enhanced responsibilities for the budget deficit and its financing.

The first change was in 1989 Banking Law\(^{96}\) that allowed the National Bank of Poland (NBP) to determine the level of credit to the budget. The same law also significantly reduced the scope of the NBP's quasi-fiscal activities into the state budget. The second change, decreed in December 1989, was to require that credit to the budget had to be covered by securities. With the maximum deficit defined by the annual appropriation laws, and limited scope for discretion ary changes on the revenue side during the fiscal year, it fell upon expenditure management to keep expenditure levels within the stipulated limits. One way to control expenditure levels was to improve fiscal management, i.e., the allocation of funds. An important step toward this goal was a new budget law, promulgated in January 1991. It replaced a 1984 law and which redefined the principles for collecting and budget funds. The new budget law allows for the possibility of executive intervention against a current budget appropriation in order to maintain economic stability. Moreover, in the event of that the planned budget balance is being threatened, the law gives authority to the Council of Ministers to block budgeted expenditures for a specified period of time provided this is approved by the Parliamentary Committee for Economic Policy, Budget, and Finance.

\(^{96}\) Ibid.
Monetary Policy

A new Act on the National Bank of Poland (NBP) and a Banking Law entered into force in February 1989. Prior to that, the NBP operated as a “monobank”, that is, it had the monopoly on traditional central banking function as well as commercial bank activities. Although the NBP ceased to be formally subordinate to the Ministry of Finance in 1982, its operations remained linked with the economic plan and monetary policy played a passive role. In this regard, the NBP was responsible for formulating an annual credit plan, and interest rates were administered taking into account the cost implications for enterprises of higher interest rates.

A key feature of the NBP Act and the Banking Law of 1989 was the devolution of the commercial banks and the NBP’s activities shall be for the “strengthening of the Polish currency”. In fulfilling its function as a central bank, the NBP has been granted considerable autonomy, although it is required each year to submit to Parliament a draft of the guideline for monetary policy that, after discussion, are voted on by the Parliament along with the budget act.

Since October 1991, monetary policy in Poland has been conducted against the background of a crawling peg exchange rate arrangement. Since the rate crawl has been preannounced and steady, this regime is analytical equivalent to a fixed exchange rate regime and serves as a nominal anchor in the system. Taking account of the likely behaviour of the demand for money, attaining inflation and international reserve

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objectives has meant that limits need to be placed on domestic credit expansion. On the one hand, attaining these limits has been complicated by the need to finance large budget deficits; on the other hand, the task of maintaining a more or less even financial keel has been assisted by the weakness of credit to enterprises.

**Capital Market Reform: Warsaw Stock Exchange**

The WSE was reopened in July 1991, some fifty years after being closed in 1939. The legal regulations regarding securities and the operation of the exchange are designed to conform to the EU standards set out in various directives; the supervision of capital markets has been entrusted to the Securities Commission, a central government agency specially created for this purpose. No restrictions are placed on foreign participation in the WSE and non-residents are free to repatriate all profits earned in Poland. Non-resident investors are subject to the same level of taxation as Polish residents. Between 1992 and 1995 all capital gains are exempted from tax, with dividend income charged at a flat rate of 20 per cent.

By January 1994, the shares of 24 companies were listed on the exchange, up from 16 at the end of 1992. (One of these companies is listed on the parallel market operated by the WSE. The securities listed on this market met less stringent criteria than on the main market of the 24 companies, 4 area banks, and others include export-import firms, manufacturing firms (e.g. glass, breweries, electronics firms, and firms in the food industry). All but two of the companies listed on the WSE were privatised through public

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98 Ajai Chopra, n. 48, p. 40.
offer. In many cases the state Treasury remains a significant shareholder with holdings ranging from 10 per cent to 47 per cent. In addition, ten Treasury bond issues are also traded on the exchange, although trading in Treasury bonds is not very active, averaging the equivalent of about $1 million a session.

Exchange Rate Developments

During the 1980s, the value of the polish zloty was determined in terms of a basket of currencies and adjusted periodically with a view to securing the profitability of polish exports. In addition to the official market, there was an unofficial market for foreign exchange where the value of the zloty was determined by market forces. As inflation accelerated, the size and the frequency of adjustments in the official exchange rate increased. The devaluation became increasingly sharp following the legalisation of the parallel foreign exchange market in March 1989. The authorities used depreciation in the official rate to reduce the size of the parallel market premium, which on average was about 83 per cent in the March – October 1989 period, and to gain competitiveness ahead of the planned unification of the markets in 1990. Indeed, the zloty was devalued ten times during the last quarter of 1989, causing the value of the currency to fall by about 90 per cent between end-1988 and the premium over the official rate fell sharply, virtually disappearing by the end of 1989. The adjustments in some of the administered prices and the liberalisation of many controlled prices during the latter part of the year also contributed to the fall in the premium by reducing the excess demand in the goods and foreign exchange markets.
As already noted, the use of the exchange rate as an anchor against inflation was a key element of the bold reform program adopted at the beginning of 1990. On January 1, 1990, internal convertibility of the zloty was introduced and the foreign exchange market for current transactions was unified at a rate of zloty 9,500 per U.S. dollar, which involved a 31.6 per cent devaluation of the official rate. Alongside the official fixed exchange rate, the parallel market rate continued to be determined freely by market forces in a market where a large number of small foreign exchange dealers (kantors) have participated.

The purpose behind fixing the exchange rate was to put a brake on Poland's emerging hyperinflation. In the latter half of 1989, the monthly rate of inflation averaged some 30 per cent. The initial rate was set with a margin, on the basis of a weighted average of exchange rates prevailing toward the end of 1989 adjusted for the effect of export incentives. The projected impact of price liberalisation and projected feedback effects on prices of wage adjustments were lagging far behind by the target at the end of first phase of capital market reform.

Privatisation

As the command and control system of central planning was dismantled, the public enterprises acquired substantial independence in the day-to-day running of their respective enterprises. However, they operated in an environment of unclear property rights with inadequate market discipline and bereft of the usual market institutions. Unlike Hungary, the system of privatisation prevailed in Poland was known as Voucher.

99 http://www.polishmarket.com/old//18_07.html
Privatisation as adopted by the Czech Republic. It would give the right to purchase enterprises without the expenditure of financial savings. At the other extreme it would be a system of case-by-case, gradual privatisation by direct sale, possibly including agreements with the final buyer regarding future investment requirements and employment protections.

After the second half of 1990, "SOEs could voluntarily choose to liquidate their assets and to sell them to private hands. Adding to this it could also give the opportunity to privatise by selling equity, by the so-called capital route or to remain in the public sector."\(^{100}\)

The other mode of privatisation was by granting the managers and workers' council an effective veto over the process of privatisation. Privatisation was voluntary, except in the case of bankruptcy.\(^{101}\) There was no time limit by which the managers and the workers' council could be forced to choose a privatisation path.

Apart from the above modalities of privatisation the other form of privatisation is known as mass privatisation programme (MPP). It was a voucher based privatisation scheme. In that case vouchers had to be issued that could be used to purchase shares in the investment funds. Though the workers and the management owned MPP large share. Though numerous difficulties has to be faced by the policy makers it could be safely summarised that considerable progress had been made and substantial privatisation had


\(^{101}\) Ibid.
been achieved. The authorities advanced the privatisation of medium and large-scale industrial enterprises through this programme.

**Commercialisation and Autonomous reform of state enterprises**

By this time, the Polish authorities had already begun the process of commercialisation of state enterprises. To improve corporate governance, the performance of enterprises were regulated by installing supervisory boards on which the treasury was represented to provide checks and balances against its activities of the management and workers’ councils. This performance of enterprises by installing supervisory boards on which the treasury was represented to provide checks and balances to management and worker’s councils and thereby improves corporate governance.

Adding to this many state enterprises had already begun to function effectively and efficiently in a spontaneous fashion. The efficient functioning was possible due to increased profits and the resultant increase in wages and salaries. However, the causes of enterprises becoming more market oriented owe to several factors. First, budget constraint hardened unlike the earlier soft budget constraint syndrome. Banks paid more attention to the quality of loans and began to charge differential interest to lower customer risk. Second, the role of managers became prominent and it emphasised profits and marketing over production targets. Third wages were not set to exhaust profits, but were the result of bargaining. Most importantly cost consciousness among enterprises increased and that it led to reduce the use of input.
Trade policy

Reforms in the trade policy began in 1990 with the abolition of state monopoly and the administrative management of foreign trade. The trade system was largely liberalised and made transparent. In the beginning the trade policy had been used as an instrument to combat near hyperinflation in 1990-91. In addition, tariff suspension was withdrawn in August 1991 to support the budget and balance of payment situation. Association Agreements\textsuperscript{102} are the vital component of the trade policy regime.

In September 1989, the European Union (EU) improved its access to Polish markets. The expansion of market access was initially through a bilateral trade and Co-operation Agreement. With the introduction of Co-operation Agreement all selective quantitative restrictions were phased out. In December 1991, the EU, then EC extended its access further to Poland with the aid of the Association Agreement. The objective of these agreements was for the progressive economic integration with the EU through a plethora of economic and financial reforms. Similar trade agreements were concluded between Poland and the European Free trade Agreement (EFTA).\textsuperscript{103} In December 1992, the agreement was signed and it came into force in November 1993.

Exchange System

The exchange system was liberalised with the introduction of a unified exchange rate in January 1990. In order to maintain the tempo of competitiveness the official

\textsuperscript{102} Paul Mylonas, "Integration into the World Economy", \textit{International Monetary Fund, Occasional Paper}, October 1994, no. 113, p. 69.

\textsuperscript{103} World Trade Organisation, \textit{Trade policy Review (Poland)}, 2000, p. 31.
exchange rate was devalued and pegged to the U.S. dollar during the same period. With the devaluation of zloty the exchange rate followed a crawling peg\textsuperscript{104} to a basket of currencies in October 1991. Residents were allowed to transact freely in this small foreign exchange dealer. Here the exchange rate was determined flexibly by market conditions, not by the command system, \textit{de facto} resulting in full currency convertibility.

Apart from the above-mentioned institutional changes some specific changes were also directed to tap the inflow of foreign direct investment into the economy. Domestic regulatory regime was one of such measures, which needs special attention particularly in the light of its effectiveness. Poland’s capacity to attract foreign direct investment has improved considerably in recent years. One contributing factor has been the liberalisation of policies controlling capital movements as part of Poland’s accession to the OECD in November 1996.\textsuperscript{105}

Since 1997, onward foreign direct investment (FDI) has increased substantially. The stock of FDI in Poland amounted to US $39 billion by the end-1999. Some 90 per cent is poured from OECD countries; EU members alone account for two thirds of inward FDI. Germany is the largest single source, followed by the United States, France, the Netherlands, and Italy.

The Polish Agency for Foreign Investment\textsuperscript{106} (PAIZ), established in 1992, is responsible for promoting and monitoring foreign investment in Poland. It provides

\textsuperscript{104} Inci Otker, "Exchange Rate Policy", \textit{International Monetary Fund, Occasional Paper}, October 1994, no. 113, p. 44.
\textsuperscript{106} http://www.paiz.gov.pl/fdi.htm
foreign investors with information matches polish and foreign partners, organises meetings of investors and carries out promotional activities.

The main law on foreign direct investment, the 1991 Law on Companies with Foreign Shareholders, was amended to fulfil European standards. Foreign companies are also subject to the commercial Code of 1934. The amended law generally provides for equal treatment of foreign and domestic investors. Foreign participation by way of limited liability or a joint-stock company is allowed. Until 1996, a joint-stock company was required for the operation of sea ports and airports; dealing in real estate or acting as an intermediary in real transactions; in parts of the defence industry not covered by licensing requirements; for wholesale trading in imported consumer goods; and in providing legal services. A limited liability company is to exclusively carry out economic activity, while the establishment of a joint-stock company allows the foreign investor to perform other activities including non-profit making activities.

Foreign investment in some activities is restricted or controlled. Permits from the relevant authority are required for mineral exploration and processing, as well as for certain manufacturing activities, including production of alcoholic beverages, tobacco, and pharmaceuticals. These are granted under the Economic Activity Act. Special provisions also require foreign investors to obtain a permit in some other activities, including radio and television broadcasting, brokerage, buses, and taxis. Restrictions on land acquisition have been relaxed to allow foreigners to purchase small parcels of land without needing governmental approval (up to 0.4 hectares within cities or one hectare

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107 See n. 56, p. 29.
within villages). Applications for permits are considered within two months of submission. The concerned Minister may deny a permit to protect Poland’s national interests or security, or to protect confidential material.

The only areas closed to foreign investors by law are those concerned with gambling and lotteries in one hand and international telecommunication services of a universal nature for the use of radio and television broadcasting equipment on the other. Telecommunication lines and networks connected directly by cable; wireless equipment or international satellites to equipment or networks outside Poland; and fishing on inland as well as territorial sea waters were also the areas closed for the foreign investors.

Polish law permits foreign ownership up to 100 per cent of most concerned but certain controls remain. For example, broadcasting legislation restricts foreign ownership to 33 per cent, foreign stakes in air and maritime transport are capped at 49 per cent, and foreign ownership in telecommunications is limited to 49 per cent for international and domestic long-distance services (including cellular).\(^\text{108}\)

Foreign partners in companies based in Poland have a legal right to transfer their profits abroad. Until December 1999 the transfer process was based on the condition that they presented to the Polish bank a certificate issued by the authorised auditors of the company’s annual financial report. Similarly, foreign partners can immediately transfer sums acquired from the sale or annulment of equity or stock owned, profits from the liquidation of a company, or damages acquired as a result of expropriation or other such measures. The Law on Companies with Foreign Participation guarantees payment of

\(^{108}\) See n. 57.
compensation to foreign investors, up to the extent of their participation in the assets of a company, for losses resulting from the nationalisation or expropriation of their assets.

Despite impressive economic growth performance and gains in reintegrating into the world economy much remains to be done to get the Polish economy further attractive for the foreign investors and to make it a viable and prospering market economy in the whole Central and Eastern Europe. Reforms of foreign trade and foreign investment institutions and policies would not accelerate economic restructuring without a sound basis for sustainable and employment creating economic growth is the cornerstone of a transition economy, needs to be established. At the same time adequate legal measures need to be added to the existing trade regime to maintain the present rate of growth and foreign capital.