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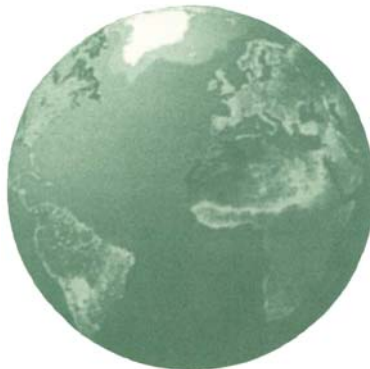
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STATE AID TO THE HUNGARIAN  
MANUFACTURING SECTOR 1990–2000



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## SUMMARY

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Hungary made big efforts in the 1990s to carry out the tasks of transition to a market economy. The economy was placed on market footing. Legislative frames were created, freedom of enterprise guaranteed, trade and capital flows liberalized, the state sector largely privatized, and state intervention through direct subsidies substantially curtailed.

The state was in the process of withdrawing from economic activity. This was also expressed in the lack or slow development of an industrial policy concept. Industrial policy (and use of state aid) was targeted mainly at investment, especially foreign investment. The underlying concept was that investment decisions might enjoy general support, while picking winners was left to the market and entrepreneurs. State aid mainly took the form of tax holidays, not direct money transfers. Since conditions for these were strict (with size thresholds, sectoral and employment preferences, *etc.*) most of those qualifying were foreign investors.

This aid policy seems to have been successful, as large amounts of investment capital poured into Hungary in the 1990s and contributed to a substantial increase in manufacturing competitiveness. On the other hand, the indirect aim of governments to channel investment towards high-technology sectors succeeded only in part. In some cases, sectoral preferences were met by investors in a statistical sense, but the activity they pursued in Hungary was not at the desired high technological level. By the end of the 1990s, the country's capacity to attract capital had been exhausted for the prevailing activity structure and further investment could be absorbed only in industries using a skilled labour force. The aid policy was not efficient in channelling investment in this direction.

Another important conclusion is that a tax holiday-dominated policy on state aid can distort the statistical overview of state aid. Since Hungary became a tax haven in the 1990s, many multinational corporations channelled worldwide profits to this country to save profits tax on activities in other countries too. Thus the 'state aid' from Hungarian governments was to some extent paid effectively by other countries but realized in Hungary. That is mainly why Hungary showed a relatively high state aid/GDP ratio in international statistics. It would be worth continuing research into this topic, as calculations could also reveal the effective unintended subsidization of other countries. Furthermore, Hungary's entry into the EU changes the picture, as tax holidays will soon end, with important effects on Hungarian aid policy and other countries' positions.

The other main line of state aid was open and covert cash subsidization of sensitive industries and single firms. This was important in the 1990s, mainly in the state-owned sector, but as privatization neared completion, the importance of cash transfers declined. The last major pre-privatization bail-out occurred in 2001, when the final major Hungarian commercial bank in state hands Postabank was rescued and then successfully privatized. Nevertheless, there seem to be problems with the figures in this regard too, as most subsidies went to economic agents through indirect channels, via the ÁPV, the Hungarian Development Bank, various development funds held by the Government (lately by the Office of the Prime Minister), or even by ministries. Official statistics for state aid in the 1990s are hardly reliable, due to lack of transparency in the state sector.

## INTRODUCTION<sup>\*</sup>

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The purpose of this paper is to describe the aid policies of the Hungarian state. Subsidy is an important policy tool for several purposes, including support for structural change in the economy, which is an important goal of industrial policy. For competitiveness, equal importance attaches to supporting development of competitive activities and revival of uncompetitive ones. The state has been playing a crucial role in both in Hungary, although the emphasis has shifted from reorganization to promotion. However, general levels of state aid have declined and the structure changed, with a gradual change in the tools applied towards those used and recommended by the EU. This has brought major changes in the content of aid activity and in reporting and statistical measurement of it. Thus the figures for 1990–95 are different in content and methodology from later data.

The paper sets out to analyse the impact of state subsidy on manufacturing competitiveness. The totality of state aid is not considered; an outline of the figures for state aid is followed by detailed analysis for manufacturing, but not for mining, transport or agriculture, for example. To show the general framework of state subsidization of manufacturing in Hungary, a brief description of the development of industrial policy is provided first. Industrial policy has determined the development tasks that were supported by state aid. This part is followed by the analysis of state aid. The analysis is divided into two periods, up to and since 1995. The statis-

tics are assessed, including their content and reliability. The role of extra-budgetary institutions is discussed in some detail.

## INDUSTRIAL POLICY CONCEPTS AFTER 1990

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The first, 1990–95 period of ‘creative destruction’ in the Hungarian transition produced three different industrial policy concepts (see OECD 1995). The first covered the requirements of market-institution development and emphasized the end to previous industrial-policy practice a tool of the command economy. With underdeveloped institutions and Comecon still operating, no strategic vision was developed in 1990. The document tried to define the role of industrial policy within the frames of a market economy. Although a shift in EU practice towards active development policy had begun, no explicit EU-compatible industrial policy was implemented at that time. The emphasis was on negative listing of what industrial policy should not do in a transforming Hungary. Nor did the policy document define specific measures of industrial policy.

Within a year or so, it emerged that the transition was bound to bring significant structural changes in the economy. Most importantly, a severe contraction and downsizing process started, which could not simply be condoned by the government. Other big changes in the economy likewise required a clear government position and sometimes intervention, for which a clear policy concept was needed. Such issues included trade liberalization, market regulation, privatization and deregulation. A new policy outline was developed in late 1992 and implemented in early 1993.

This concept was designed for the medium term. It described the potential

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variety of policy measures to enhance corporate adjustment without risking a return of excessive intervention. The document also contained a foresight model of Hungarian industrial development, on which suggestions for policy goals and tools were based. The prognosis proved largely correct, at least for the advance of economic recovery and growth resumption by main industries, but it did not envisage the ongoing crisis in several industries, or the concurrent presence of tardy and successful businesses in the same industries (dual structure). Unlike the first concept, the second did not rely greatly on ownership changes as a panacea. It introduced the possibility of ‘crisis management’ support for some state-owned firms of strategic importance (the dirty dozen).

Crisis management included directly and indirectly subsidizing 12 (later 15) firms. Török (1997) estimated the total cost of these measures to USD 1.5 billion. This included direct cash transfers from various sources (central budget funds; the State Property Agency as ownership representative), write-offs of payment arrears (taxes; health-service contributions; banks and commercial creditors, at least partly using state funds), development and restructuring funds (payments for reorganization investment, technology updating, *etc.*) Half the affected firms survived and were privatized. Others were sold piecemeal. Some parts remained in indirect state ownership, joining the portfolio of the state-owned Hungarian Development Bank and its successors.

Crisis management became an important area of industrial policy and remained so later. Indirect asset management was still carried out through state-owned mediators. The portfolio increased and changed, as some private or privatized firms that failed ended up with these ‘development agencies’. The biggest increase in volume was achieved with two waves of corporate and bank consolidation affecting about 150 compa-

nies. The emphasis had therefore shifted in the second industrial-policy concept from following strategic development targets to state crisis management. Long-term structural policy lacked funding and energy, however (see Szanyi 1996).

The third industrial-policy concept, developed in 1995, was based on a more specific vision, with a strategic background of EU accession requirements. It contained a detailed system of promotion tools and a set of EU-compatible development goals. The major tools were orientation and support of R and D, support for small and medium-sized enterprises (SMEs), regional policy, and in exchange for ‘targeted’ preferences for FDI projects, a normative system of investment promotion. The prime objective was to enhance long-term economic competitiveness. This goal has remained, despite various changes of concept. It was also in line with EU policy guidelines, which had been formulated explicitly by then. The goals and tools were coordinated with EU competition-policy requirements and did not intervene to conserve failed industrial structures.

Both the second and third concepts held sectoral preferences that changed over time. The second concept’s preference was exemplified by the companies chosen for crisis management, which were in the automotive, electrical-appliance and chemical industries. But crisis management of a few large firms did not involve implementing a thoroughly developed concept of sectoral restructuring. Preference was given to some former flagship companies in Hungarian manufacturing and to other firms for regional employment reasons. The shift showed clearly in the increase from 12 to 15 recipient firms and the inclusion of metallurgical companies. The use of state subsidy in crisis management varied between firms according to whether decline or expansion was expected. As Szalavetz (2003) pointed out, support for growing and declining in-

dustries required different policy tools, whose efficiency was reduced because differing industries were placed in the same framework. Szanyi (1996) reported that 5–6 of the 15 were effectively bailed out, another 4–5 showed reduced or substantially changed activity, and 4 made an exit.

The 1995 concept used different sectoral preferences. Instead of crisis management, the leitmotif was to improve competitiveness, although this did not mean an end to crisis management or even direct subsidization of a number of ailing companies, as happened in the steel industry, for example. The major change was that state ownership became indirect and money transfers flowed through state-owned ‘development agencies’, not directly from the state budget. This resembled the practice of the consolidation banks in the Czech Republic. Most of the 1995 concept’s real developments were applied generally, but some assertive development paths were given official preference. These industries had attracted FDI and the policy concept sought to rely on such investment and enhance its spillover effects. Thus the automotive and electronics industries, software development and some chemical segments became prime targets.

The problem was that industrial policy had very few active tools to enhance structural changes, due to major macroeconomic imbalances. The most effective were fiscal incentives and in some cases contributions in kind, such as free transfers of industrial premises. SME development, as another industrial policy tool, involved minor amounts in the form of preferential credit schemes and guarantees. After 1994, the SME sector did not receive any fiscal incentives (tax preferences or cash subsidies). Regional and structural policy (in the EU manner) mainly affected foreign investments. Central development funds were used for projects that reached a threshold level in terms of job creation, R and D spending, export performance, further invest-

ments and turnover growth. Local-government tools were also used to attract large investments.

MITT (1997), an official document, stressed these priorities in industrial policy:

- \* Priority for accelerating industrial restructuring, to promote competitive structures.
- \* Increasing harmonization of industrial-policy instruments with the requirements arising from Hungary’s international commitments.
- \* Tackling major industrial-development tasks such as concluding privatization, restructuring sensitive industries, support for FDI, harmonization of infrastructural developments, regional development strategy, and export growth.
- \* Tasks related to legal harmonization and cooperation.

It designated as key areas stimulation of investment (in general, but most importantly, FDI), supporting corporate R and D and innovation, developing supplier networks to foreign firms, and raising exports. The most effective industrial policy (and FDI attraction tools) in the period were fiscal incentives and industrial free-trade zones.

A fourth and most recent development in industrial policy occurred with the preparation of the National Development Plan, and its predecessor the Széchenyi Plan in 2000. The Széchenyi Plan was a logical continuation or updating of the third concept. It developed further the range of industrial-policy tools in harmony with international obligations and with the expected EU requirements for the accession talks. In fact, the tools underwent continual change during the accession process, the last major revisions being made in 2002 (lifting of tax subsidies and withdrawal of industrial free-trade zones). This harmonization process necessarily meant a steady contraction in direct state subsidies. The indirect forms of subsidy through state-controlled development agencies remained in place,

opment agencies remained in place, and so did large subsidies to some major state-owned enterprises such as Hungarian State Railways and Malév Hungarian Airlines. The last major bank consolidation procedure, for the Postabank, was carried out and the bank sold to foreign investors in 2003. The new terminology to cover subsidies is ‘state venture-capital funding’, which has nothing in common with traditional venture-capitalist activity.

The Széchenyi Plan and Hungarian Development Plan developed further the concept of FDI-based development. It effectively continued large-scale investment, although rather limited funds for SME and tourism development were included. The most interesting innovation was support for FDI spillover effects by various means. An FDI supplier-network creation programme was introduced, as well as support for the creation of industrial parks, especially those with some R and D or innovation activity. This latter topic was also supported by other tools, like a cluster programme of support for cooperation among big business, research institutions and higher education. Emphasis on innovation and the requirements of a knowledge-based economy marks the whole document (Csillag 2003), for example parts dealing with development of human resources, infrastructure systems *etc.* The predominance of future-oriented development tasks was clear compared with the crisis management pervading previous policy concepts.

Industrial development practice is analysed in Tétényi (2000), with a view to EU accession requirements. This technical paper is very critical of the development focuses and practice before the advent of the Széchenyi Plan (the third concept). Even if the previous concepts are seen as steps in an iterative concept-development process, the criticism seems correct. Tétényi (2000) says that the structural development of the Hungarian economy was largely a result of capital imports (FDI) and economic crises (downsizing, liquidation), rather than of

active industrial policy, with clearly political overtones in a number of policy measures. Policy-makers were much against planning and direct support. The campaigns of withdrawal by the state from business resulted in an abrupt drop in state-budget financed investment. State ‘investment’ was partly channelled into covert forms, such as the development agencies. This decentralization of state spending decreased the efficiency of the tools. As Tétényi puts it, ‘This inefficient structure was even supported with the ideological argument that “private use” of capital meant greater efficiency.’ This indirect, decentralized and sometimes spontaneous means of state development promotion is regarded by Tétényi as an inferior method of capital utilization. On the other hand, he foresees a new, transparent, effective, EU-compatible system of structural policy, planning and resource allocation.

Nikodemus *et. al.* (2000) also stress that Hungarian planning practice and preparation of the National Development Plan were inadequate. They argue that given the time limit (submission of the plan to the EU Commission was due one year before accession), the NDP was at a very immature phase. Much of the decimated planning capacity was charged with preparing the Broad Development Plan and not much time was devoted to the details. Even the creation of regions (instead of the existing counties as second-tier local-government units) was not completed by 2000, let alone the regional development proposals. And what was ready was substandard in many respects – very much the result of conflicts in the earlier, partly communist-inherited planning regime and the EU-compatible task and indicator-oriented planning methods. The Széchenyi Plan, and later the National Development Plan, tried to bridge this methodological gap.

The current version of the Széchenyi Plan includes two main pillars. The first is a remnant of the previous fiscal-incentive system for FDI, the Smart Hun-

gary programme. Investment promotion now accords with EU practice, tax incentives being used for regional development, R and D, and adult education, with a possible tax-free reserve for development. There is also some direct support for creating business locations, supporting the establishment of regional corporate centres, and competitive and environment-friendly investment support. The total allocated to the Smart Hungary programme is very limited, as are its tasks. The other pillar is the Széchenyi Enterprise Development Programme for supporting SMEs. This contains free transfer of knowledge on the EU, support for competitiveness-enhancing projects and preferential credit schemes. The total budget for the two projects is about 600 million Euros (Szalay-Berzeviczy 2003).

The support of industrial parks, and clusters are two important, relatively new elements of the Széchenyi Plan. They seem to be suitable for several purposes. First, they are EU conform regional development tools. Second, they focus on the establishment of cooperation between FDI and Hungarian business. Third, they have a clear technology transfer and innovation content. Fourth, clusters also include a broad spectrum of business and society, it is not only business cooperation. Clusters and industrial parks may receive funding from the central budget, but also from local governments, and later probably also from EU funds (Nikodemus and Gecse 2002). They may even have some sectoral preferences (technology intensive activities). On the other hand, as Szalavetz (2003) points out, some of the successful economic clusters contributed to the diffusion of high technology rather in mature industries, and became this way part of the management of sensitive industries.

In this sense, a basic conceptual change should be made: technological renewal of sensitive industries inevitably leads to further job losses as new technologies save labour. Thus they can sup-

port competitiveness. Hungarian practice is in this sense rudimentary. Sensitive industries are not tackled by the National Development Plan and the practice of indirect state subsidization of a number of firms continues, mainly for employment reasons. Hungary lacks a concept for technological renewal of sensitive industries.

## STATE AID UP TO 1995

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Monitoring forms of state aid in Hungary started in 1995, in accordance with Article 62 of the EU Association Agreement. Regular reporting and adjustment of the subsidy system to EU practices started in 1996, the first year for which Hungarian statistics comparable with those of the EU statistics are available. However, they may have different content when subsidizing practice had not yet been adjusted to EU rules. For example, Hungarian statistics included amounts of subsidized loans, while EU members registered only saved interest on these. Apart from the areas with some conceptual difference, Hungarian data was accepted and used by the EU authorities. The year 1996 was a turning point in other aspects of Hungary's economic development as well. It was the last year of massive direct state subsidy. State-assisted reorganization, recapitalization of banks and other large-scale projects were completed. The practice with state aid moved irrevocably towards conformity with EU standards.

However, subsidy reduction had begun before the 1989 change of economic system, as the communist government reduced several industrial and consumer subsidies in the late 1980s. The decline in consumer price subsidies began to speed up in 1989, so that few other than for pharmaceuticals and public transport remained by 1992. Mean-

while the Antall and Boross governments (1990–94) continued to reduce subsidies to industry and agriculture, especially as trade destinations shifted from former Comecon countries to EU partners. Annual subsidy of all kinds as a proportion

Table 1  
State subsidy  
(USD billion)

	1988	1989	1990	1991	1992	1993	1994	1995
Consumer subsidies	1.32	1.16	1.03	1.07	0.79	0.83	0.92	0.83
Housing sector	0.62	1.46	1.66	1.26	1.29	1.01	0.90	0.95
Producer subsidies, of which:	2.97	2.16	1.71	0.80	0.77	0.68	0.98	0.69
• Agriculture	0.86	0.71	0.58	0.51	0.42	0.49	0.60	0.46
• Railways	0.09	0.09	0.07	0.04	0.11	0.05	0.25	0.12
Total including unlisted items	4.90	4.77	4.39	3.12	2.84	2.51	2.79	2.46
Subsidies as propor- tion of GDP	17.10	16.70	13.30	9.40	7.60	6.50	6.80	5.60

Source: Ministry of Finance. In: CEEBIC 1997.

of GDP dropped steadily from 17.1 per cent in 1988 to 5.6 per cent in 1995 (Table 1).

The Antall, Boross and Horn (1994–8) governments granted substantial subsidies to state-owned banks during pre-privatization consolidation exercises, with the state taking over much bad debt. Although this bail-out did not feature in the current account, it was essentially a subsidy. The government was contracting public debt in the form of Treasury bills so as to inject vast amounts of capital into the ailing banks. CEEBIC (1997) quotes István Csillag, then director of the Financial Research Institute (and currently minister for the economy) as saying that bank consolidation in 1993–6 cost about USD 4 billion. Privatization of many manufacturers also involved indirect subsidies to improve their liquidity positions, cover the costs of environmental clean-up or serve other purposes. The main aid vehicle in the sector in those years was the state-owned State Privatization and Asset Holding PLC.

Since late 1995, continued privatization in the energy, banking and manufacturing sectors has much reduced the subsidy commitments of the state. For example, privatization of over 70 per cent of the Hungarian energy sector led to a big saving in subsidies to energy producers and consumers. It took several more years to close down loss-making coal-fired power plants and the mines serving them. (Closure of the last such colliery was announced just recently.) Despite substantial increases in consumer energy

prices in the last 10 years, prices are still lower than world levels. Foreign energy firms continue to seek price increases to cover production costs plus the agreed 8 per cent profit margin.

Hungarian governments in the 1990s maintained steady levels of subsidy to agriculture and other rural activity. Of the USD 400–600 million total, more than half went to subsidize agricultural exports. This ceased in 2001, when Hungary's agreement with the EU expired and the practice of EU-related export subsidies was discontinued preparatory to EU accession. Agricultural export subsidies then gave way to rural development subsidies for housing, road construction and railway running costs.

Although the level of state subsidy can be seen to have fallen substantially, post-1996 figures are not wholly comparable with earlier data due to changing rules of spending and reporting. The data from 1996 onwards follow EU rules. For the purpose of comparison, we include here figures from Hungary's Central Statistical Office (CSO) that do not conform with EU requirements, but



are more or less comparable with the data in the previous table. (However, they are not USD figures, and the total does not include other items than the first four rows.) Comparing these figures with those in *Table 4*, there is considerable consistency, so that there should not be major methodological differences in the EU rules and CSO methods. State aid paid to economic units seems to be very close in both tables. Other figures in the table also seem to be acceptably reliable.

Table 2  
State subsidies in 1997–2002 as a percentage of GDP

	1997	1998	1999	2000	2001	2002
Consumer subsidies	0.6	0.76	0.75	0.72	0.70	0.70
Housing sector	0.79	0.48	0.41	0.43	0.46	0.51
Producer subsidies	1.52	1.51	1.77	1.56	1.65	1.67
Out of which: agriculture	0.96	0.84	1.02	0.84	0.92	0.80
Total	2.91	2.75	2.93	2.71	2.81	2.88

Source: CSO and own calculations.

*Table 2* shows that state subsidy had fallen by the second half of the 1990s to a fairly stable level of under 3 per cent of GDP (CSO classifications). The structure varied year by year, with agricultural aid especially volatile due to the sector's special circumstances.

## STATE AID AFTER 1995

Hungary had to provide the EU with annual data and information on state aid, under Article 62/4b of the EU Association Agreement. Reports were prepared from 1996 using a developing institutional and methodological background. For example, local government aid practice was not included in the reports until 1999. So the content of the figures changed over time, so that increases in nominal figures may be due partly to inclusion of extra activities and amounts into the aggregates. Furthermore, differences remain between the

Hungarian and EU reporting systems and resulting figures. There are also inconsistencies between data in this paper and CSO data, since the CSO continues to gather by the old methodology. This section uses data provided by the Aid Control Office (ACO) of the Ministry of Finance, which is largely compatible with EU methodology and better suited to the international comparison purposes of the competitiveness project. All data comes from TVI (2002), the last official report of the ACO. The analysis comes from there too and is only interpreted by the author.

State aid is granted in Hungary for financing development programmes and on an ad hoc basis. *Ad hoc* aid is channelled through specialized government agencies (mainly the State Privatization and Asset Holding PLC and the Hungarian Development Bank). Direct *ad hoc* subsidies are on the decline, but this is partly affected also by problems of consolidating aid data. We return to this problem later.

Eight chapters in the central budget are involved in distribution of state aid. Direct financial supports are obtained through the frameworks of 'targeted allocation funds' (TAFs): the TAF for Economic Development, the Central Basic Technological Programme, the TAF for Rural Development, the Labour Market Fund, the Regional Development TAF, the Tourism TAF, the Environmental Fund, and the SME Development TAF. The forms, including preferential bank loans, refundable and non-refundable grants, and interest subsidies, are available to companies registered in Hungary and awarded by competitive application and go mainly towards investment projects, small business, underdeveloped regions, environmental protection and R and D investment. They normally cover 30 per cent of investment costs, with a ceiling of HUF 200 million.

*a. Targeted Allocation Fund for Economic Development (TAFED)*

Several application systems function under the TAFED, which is administered by the Ministry of Economic Affairs (support for investment projects and domestic component supply, establishment of industrial parks, promotion of SMEs, etc.) The application system for economic development is the main tool for promoting FDI. Investments to produce an annual output of more than HUF 50 million or establish at least 50 hotel rooms are eligible. Projects must be completed in two years (those costing over HUF 3 billion in three years) and pay for themselves in local added value in five years. Investments meeting these requirements can obtain:

- \* Interest-free loans of up to 25 per cent of investment cost with a ceiling of HUF 200 million (HUF 400 million for investment costs exceeding HUF 3 billion).
- \* For greenfield projects, non-refundable grants of up to HUF 200 million for up to 100 per cent of the costs of installing necessary infrastructure beyond the premises.

Grants may be 10 per cent higher – up to 27.5 per cent of investment costs, maxima of HUF 200 or 400 million – for projects in regions designated as in the least developed category and for participants in the supplier target programme. The sum

of all grants from the TAFED and other state funds may not exceed 50 per cent of investment costs. The application system is built on a principle of national treatment and does not give preference

to foreign investors. However, the significant own-capital requirement has meant that the interest-free loans and grants have gone mainly to foreign investors in recent years. *Table 3* shows the grants in 1998. Of the HUF 12 billion of funds applied for in 1999, HUF 8 billion were connected with foreign investors. The TAFED resources available in 2000 totalled HUF 17.2 billion. Grant strategy was affected by some changes in economic policy. FDI promotion was joined as a main goal by introduction of modern technologies and products. Grants to foreign companies settling in Hungary should further their adaptation into the local economic environment and strengthen their ties to domestic suppliers and cooperation with other companies. In 2000, 48 per cent of TAFED resources went to promote investment and the supplier industry. Another 15 per cent went to collective investment and trade development, 6 per cent each to energy-saving programmes, introduction of quality guarantee systems and individual trade-development projects, and 9 per cent to narrow the gap for counties in the worst economic situation and the most underdeveloped regions.

Table 3  
Grants of larger amounts in 1998, HUF millions

Name of company	Subject of development	Grant	Loan
1. Caterpillar Hungary	Expansion of capacity	0.00	180.00
2. Curver	Expansion of capacity	50.00	300.00
3. Denso Hungary	Fuel-injector pump production	200.00	200.00
4. Ford Hungary	Modular fuel-pump production	9.70	266.60
5. GE Lighting Tungsram	Halogen car-lamp development	0.00	200.00
6. Luk Savaria	Clutch production plant	42.70	200.00
7. Philips Monitor	Computer monitor production	0.00	200.00
8. SCI Hungary	Electronic assembly plant	112.40	287.60
9. Sony Hungary	Video apparatus production	0.00	200.00

*Source:* Ministry of Economic Affairs. In: Antalóczy 2000.

*b. Targeted Allocation Fund for Regional Development (TAFRD)*

The grants are supposed to narrow the gap between developed and underdeveloped regions and settlements and avert the development of further regions of economic crisis. The following regions are given high priority:

- \* underdeveloped areas with below-average economic and social indices,
- \* regions of change in industrial structure,
- \* regions of agricultural and regional development, and
- \* regions with high rates of long-term unemployment.

The forms of support are:

- \* non-refundable grants,
- \* refundable grants, and
- \* grants connected with development loans.

The upper limit on TAFRD grants for job creation is HUF 1 million per new job. Interest subsidies may not exceed 50 per cent of the total interest on a loan. With investment projects creating over 50 new jobs and producing internationally competitive products, at least 50 per cent the upper limit of grants awarded can be exceeded by 10 per cent and the upper grant limit per new job by HUF 500,000. Programmes eligible for TAFRD are:

- \* job-creating investments,
- \* productive infrastructure investments (installation of energy, traffic, water and sewage systems, communications, or disposal of regional waste),
- \* EU-supported development projects,
- \* innovation projects,
- \* development of entrepreneurial zones, industrial parks and incubator houses,
- \* development projects involving several counties.

*c. The Labour Market Fund*

The aim is job creation for long-term unemployed, in regions where employment is a big problem, and encouragement for businesses to create competitive jobs. The scale of eligible grants – refundable or non-refundable interest and capital subsidies – is determined case by case by labour-market centres.

*d. Support for R and D development*

The Commission for Technical Development launched and several ministries supported an incentive for projects costing at least HUF 500 million and employing at least 30 researchers in R and D research institutions connected with high technology. The support may not exceed 25 per cent of the amount invested. Bulk of state aid is provided through tax allowances, the preferred tool of poorer nations, rather than as direct cash transfers. Instead of redistributing current income, the state gives away future potential income. This is an important advantage for companies, especially for large multinationals, which can transfer pre-tax income globally through various channels. Exemption from corporate income tax in Hungary, for example, moved profits from many other locations, thus boosting the tax-holiday element in Hungarian state statistics on aid. An officially acknowledged example has been Audi. The German carmaker announced that 80 per cent of its worldwide profits had been ‘produced’ in Hungary in 2001. The many highly ‘profitable’ Hungarian multinationals add huge amounts of latent, unrealized corporation tax to Hungary’s aid records. The main possibilities of receiving tax allowances in Hungary during 1995-2001 were the following (these incentives were available until 2001, but already obtained allowances remain in effect until expiration).

### *a. General tax allowances for investment*

A 50 per cent tax allowance became available on January 1, 1996 for investment projects aiming to establish production facilities, valued at a minimum of HUF 1 billion over a period of five tax years, provided those years saw:

- \* net sales growth over the previous tax year of at least 5 per cent of the investment value, or
- \* net sales at the level attainable if net sales had grown annually in that way.

The same tax allowance was made available for investments to establish hotel facilities commenced after December 31, 1996 and valued at a minimum of HUF 1 billion, for a period of five tax years, in which:

- \* net sales grow by at least 25 per cent, but at least HUF 600 million over the previous tax year, or:
- \* net sales reach attainable level if net sales had grown annually in that way.

A company received the full the full allowance for 10 tax years at productive facilities established for at least HUF 10 billion after December 31, 1996, in tax years in which:

- \* net sales increased over the previous year by at least 5 per cent of the investment value, or:
- \* net sales reached the level attainable if net sales had grown annually in that way.

The tax allowance was available only from the second year after start-up, when the average number of employees exceeded by at least 500 persons the number of employees in the year preceding commencement of the investment project.

### *b. Regional tax preferences*

Regional tax preferences are available for productive investments or for investments establishing hotel facilities in high priority regions and/or industrial parks.

- \* Entities in a high priority region and/or entrepreneurial zone, producing new products or providing hotel facilities, are entitled to full exemption for five years after start-up, provided net revenue from new production in such a zone increases by at least 1 or 5 per cent of investment value respectively.
- \* Investments in an underdeveloped region with a minimum value of HUF 3 billion, begun after December 31, 1996, and are entitled to exemption for 10 tax years after start-up, provided net revenues from new production increases by at least 5 per cent of investment value and the workforce increases by at least 100 over the number in the year before commencement.
- \* A tax preference of 6 per cent of investment is available in the year when the investment facility opens, for companies operating:
  - in a high-priority region, on the value of machinery installed,
  - in an entrepreneurial zone, on the value of machinery installed and premises built, and
  - in a high-priority region or entrepreneurial zone, on the value of infrastructure installed.

### *c. Tax allowances to stimulate R and D activity*

A tax allowance of 20 per cent of direct costs (developers' direct salaries plus contributions, materials, semi-finished and finished products, intellectual products, purchased patents and know-how, licence fees, expert fees) in a tax year is given for R and D.

Budget funds are partly decentralized. Much of the TAFRD goes to local government, but there are transfers from other funds to at least five developed counties in Hungary.

Table 4  
State aid provided to economic units  
(million Euros)

	1996	1997	1998	1999	2000	2001
Total aid, of which	577.7	765.0	836.8	689.0	800.1	800.5
• Manufacturing	336.1	509.3	523.2	375.9	479.2	442.1
• Transportation	220.9	223.5	290.3	291.3	304.1	276.5
• Coal mining	20.7	32.2	23.3	16.1	12.6	16.2
Total aid as percentage of GDP	1.6	1.9	2.0	1.5	1.6	1.5
Per capita aid (Euros)	56.5	75.2	82.6	68.3	80.0	80.0
Aid per employee (Euros)	152.7	209.8	226.3	180.9	207.9	N/A
Aid as a percentage of central budget expenditures	3.28	3.80	4.01	3.26	3.44	N/A

Source: TVI, 2002, p.12.

The percentages are much lower than in Tables 1–2. There was certainly a great drop in subsidization, but it results from method changes. Figures in *Table 4* are comparable with EU standards, but reflect only a fraction of state aid provided for various economic and social aims or to non-profit organizations and local government, which was done in a large number of cases. Moreover, agriculture and fishing are not included. About 1 per cent of GDP went to manufacturers in the form of state aid. Roughly 0.5 per cent of GDP helped to finance the transport sector, mainly Hungarian State Railways.

After the usual EU breakdown of subsidy goals, it is possible to discern main groups: horizontal, sectoral and regional. Of the horizontal goals, TVI distinguishes R and D, environment, SME development, employment, and education/training. Of the many industries eligible for EU aid, only Hungary's steel industry is affected. It is also important that many winning projects featured two or more goals. In general, the projects were ordered according to main goal. *Table 5* gives manufacturing data broken down in this way.

Two interesting changes can be observed in this table, both occurring in 1998. First,

bail-outs and restructuring ceased. This does not mean, that intermediaries of the state also stopped such activities. It means that no large-scale intervention was made after that time. In fact, both the 14.7 per cent and 2.9 per cent figures refer to steel-industry subsidies. There was only one major rescue later, of the Postabank, which has been referred to already, but it was a 2001 case and not a manufacturing case, so that it does not appear in this table. Furthermore, general sectoral aid was in decline, although there was a jump in 1997. It seems, that in the longer run, most aid was provided on a regional basis (the vast majority is tax allowance), while projects that cost real money accounted for only 10 per cent of total aid

Table 5  
State aid for manufacturing companies broken  
down to purpose of the aid  
(%)

	1996	1997	1998	1999	2000
Horizontal aid	13.2	15.8	12.8	8.2	9.3
• R and D support	1.5	1.8	1.6	0.6	1.0
• Environment	1.2	4.7	4.8	4.7	3.6
• SME development	4.0	3.7	4.4	2.8	4.6
• Employment	4.2	3.3	1.0	0.0	0.0
• Education, training	0.3	0.3	0.0	0.0	0.0
Rescue and restructuring	14.7	2.9	0	0	0
Sectoral aid	3.7	14.3	5.2	1.9	0
Regional aid	68.4	67.0	82.0	89.9	90.7
Total	100	100	100	100	100

Source: TVI, 2002, p.17.

Table 6  
State aid for manufacturing firms broken  
down by aid categories  
(%)

	1996	1997	1998	1999	2000	2001
Non refundable subsidy	34.28	25.05	22.33	12.46	18.36	26.29
Tax allowance	58.76	58.28	72.90	76.21	76.82	71.04
Interest subsidy	1.46	2.87	0.71	1.84	1.41	0
Equity share	0	0	0	0	0	0
Interest free loan	2.86	4.60	3.60	7.58	2.01	0.39
Guarantee	2.64	9.20	0.46	1.90	1.41	2.28
Total	100	100	100	100	100	100

Source: TVI, 2002, p.20.

in horizontal projects. According to TVI (2002), the amount of tax allowances increased from 200 million Euros to 360 million over the 1996–2000 period, while direct aid to manufacturing grew from 40 million Euros to 70 million. Sectoral programmes were gradually eliminated as the privatization process drew to a close. No special programmes accessible to whole industries remained available in Hungary. The elimination of employment and education aid in horizontal aid shifted the emphasis onto supporting individuals and onto new, generally accessible, not aid-like tools.

The structure of aid hardly changed in 1996–2000. Non-refundable subsidy and tax allowances were the most important forms (95 per cent), but direct cash subsidies lost significant weight to tax allowances. *Ad hoc* aid also lost importance. In 1996, almost 20 per cent (63.9 million Euros) of total manufacturing aid was channelled through the privatization agency as *ad hoc* aid, but by 2000, there was no Hungarian *ad hoc* aid officially regis-

Table 7  
Tax allowances on local business tax provided  
by local government, million Euros

	1999	2000
Total local tax revenue	785	857
Revenues from local business tax	678	725
Tax holidays on local business tax	48	42

Source: TVI, 2002, p.26.

tered. All official aid was distributed through aid programmes.

Local governments support business ventures through several channels. Cash subsidies and tax allowances counted as official aid under Article 62 of the European Agreement. Tax allowances have been collected by the Aid Control Office of the Ministry of Finance since 1999.

Reporting of cash subsidies started in 2002. The amounts and relative share of allowances are not high, but still significant, as *Table 7* shows.

## SOME METHODOLOGICAL ISSUES

Many intrinsic and formal inconsistencies in state aid practice and monitoring in Hungary have been mentioned. In fact, the system is under development and full convergence cannot be expected to follow EU entry, as many tax allowances obtained earlier will remain until agreements expire, making the effective subsidization practice different from the EU standard. Full convergence can be expected by the end of the decade.

Most important here is the absence of consolidation of aid sources. There are two main state-controlled institutions carrying out activities that may influence competition and competitiveness. These are not monitored effectively by the State Aid Control Office. These are the State Privatization and Asset Holding PLC (ÁPV), and the Hungarian Development Bank. Both institutions served as corporations, have legal personality, but carry out active role in the execution of the policies of the Hungarian Government. The monitoring is difficult,

because their state controlled functions are mixed with ordinary commercial activities. On the other hand, they also may use their revenues for cross-financing different projects. This means, that potential state budget revenues are used in these two organizations for various purposes, including subsidizing. Since the revenues are not transferred to the budget or redistributed formally, they are not fully included in aid statistics either. This is especially the case with the Hungarian Development Bank, which is relatively independent of the state. The privatization agency is more strictly controlled and monitored by the government and Parliament, and reports on the structure of its spending, which is included in the Aid Control Office reports as well.

This inconsistency was also stressed in one of its fiscal transparency report by the IMF (2001). This referred to 'inconsistencies in terms of incomplete coverage of non-profit organizations that perform governmental functions,' and 'exclusion of the Motorway Co. Ltd and the Hungarian Privatization and State Holding Company from the central government.' The governmental segment of the non-profit sector includes 36 public trust funds (foundations established by Parliament, government or local government) and about 100 public-service companies (publicly owned corporate vehicles to provide public services such as road maintenance or transportation under contract from ministries or local government authorities). According to the

IMF report, budget spending through these agencies amounts to less than 1 per cent of the total. The Motorway Co. Ltd. is a joint-stock company, wholly owned by the Hungarian Development Bank, that undertakes road building on behalf of the government and is financed ultimately by the budget, albeit via the Hungarian Development Bank through a variety of means. Before 2000, financing of road construction was provided directly through the state budget. The ÁPV was taken out of the budget in 1996 and its financial operations are currently recorded in the fiscal accounts only insofar as it pays dividends and part of the proceeds of privatization to the budget or receives budget transfers. The latter transfers are also recorded by the Aid Control Office.

Hungary has substantially reduced its ownership of commercial firms. Its holdings are currently concentrated in electric power transmission, the country's one nuclear power station, public transport, and state forests and farms. The government has also retained a limited number of 'golden shares' in telecommunications, banking, energy, and other activities. However, a number of public financial institutions and non-financial public enterprises are required to undertake non-commercial activities on the

Table 8  
Aid-like expenditures by the ÁPV, HUF million, current prices

	1995	1996	1997	1998	1999	2000	2001	2002
Reorganization of firms	9792	15670	16498	13458	14978	6585	3941	1689
Environmental clean-up					4480	3973	2468	1191
Other liabilities (e.g. due guarantees)	3647	8222		1162	1500	4471	5030	272
Transfers for various development projects	241	13000	8000	13500	8500	10000		
Debtor consolidation		81	12000	219				
Emergency payment due to privatization				52702				
Total	13680	36973	36498	81041	29458	25029	11439	3152

Note: The table combines expenditures formally financed by firms controlled by the ÁPV or by asset sales and expenditures financed out of the ÁPV budget.

Source: ÁPV.

state's behalf, typically in infrastructure, agriculture, housing, foreign trade and health care. Support for such non-commercial operations is provided either directly from the budget by the ÁPV or by issuing government guarantees. The Hungarian Development Bank is required by a government resolution to participate in development of the state infrastructure, financing of SME support projects, and other state initiated projects. With the first, the bank provides financing for the Motorway Co. Ltd, for instance. The government in turn guarantees credits extended by the bank for road construction and is required by another government resolution to provide regular capital injections to the Development Bank, drawn in part from the budget and in part from the ÁPV. IMF (2001) argues that such complex financial manoeuvres are not readily transparent or under full aid control.

The annual reports of the ÁPV can be used to assess its financing role. *Table 8* contains some details of this. As the IMF report pointed out, transactions in which the ÁPV takes part are not quite transparent and it has only been possible to guess at which items in the annual reports are likely to have had an aid content. The figures by no means reflect specific additional amounts to the official data. They simply illustrate the trends. Two are obvious. First, aid through the ÁPV was most widespread when there was a lot of privatization revenue coming in. Until 1996, the bulk of the revenue was collected by the state budget and relatively little used through the ÁPV for aid purposes. Reorganization and transfers to other development projects were the major aid means. Substantial amounts were also paid out for state guarantees.

In 1996–8, the ÁPV participated in the debt consolidation programme, which had a 100 per cent aid content. In 1998, there was a major transfer labelled in the report as ‘emergency payment due to privatization’, but no fur-

ther details are known. ÁPV also began to finance environmental clean-up projects. Transfers to the central budget and to other state sponsored aid programmes dwindled as the privatization process drew to a close. In other words, lack of further privatization revenues curbed the ÁPV's role as an aid dispenser.

However, the ÁPV is still majority owner in a number of commercial ventures. According to the figures, there were 37 firms in long-term state management in January 2003, with a combined book value of HUF 260 billion (1 billion Euros). The bulk of the value was accounted for by the Hungarian State Railways, Malév Hungarian Airlines and holdings in the energy sector. The state interest in manufacturing was minor. There was one major steelworks, but it was up for sale. There were 81 other companies still for sale, with a book value of HUF 137 billion. Some cross-subsidization can be assumed in some cases, for available information suggests that the steelworks, for instance, ran at a loss in last two years, and so did the railways and the airline.

Similar considerations apply to the state-owned Hungarian Development Bank. It has been mentioned already how the bank is involved in various state development programmes. It also has interests in several manufacturing companies, through a portfolio that goes back to the debtor consolidation programme of 1995–6. The bank itself was established to gather up the assets of ailing manufacturing companies that the government thought to have some national strategic importance, or that were better off than average. Thus the bank started life as a professional reorganizing body. After successful stabilization and reorganization of several companies, these were sold, but others could not be saved, so that the portfolio contracted to a handful of firms hardly viable without state support. The bank possessed equity in 55 commercial companies, mostly in services or finance. The few in manufacturing were



important as single survivors in traditional activities such as handicrafts or traditional clay products.

Table 9 shows the size and sectoral distribution of the state-owned sector in manufacturing. It can be interpreted as a guide to the sectoral distribution of state aid, as far as direct cash subsidies for state firms are concerned. In very few industries does the state share ex-

ceed 10 per cent. In branches 171, 201, 241, 274, the state share declined due to privatization or liquidations. More surprisingly, there were five branches (332, 352, 354, 355 and 362) where the state sector expanded significantly: State firms are dominant only in 296 weapons and ammunition, 355 other non-specified vehicles.

Table 9  
Sectoral distribution of state-owned companies  
(% shares in production and employment of manufacturing industries)

Sector (NACE 3-digit groups)	1998 State output (sales)/total output (sales) *100	1998 State employment/total employment *100	2001 State output (sales)/total output (sales) *100	2001 State employment/total employment *100
151	1.24	1.63	1.08	1.32
152	0.00	0.00	0.00	0.00
153	0.00	0.00	0.80	0.61
154	0.01	0.25	0.00	0.00
155	0.00	0.00	0.38	0.87
156	0.00	0.00	0.93	0.92
157	1.62	4.91	0.95	0.92
158	0.24	0.63	0.08	0.21
159	1.11	3.06	0.11	0.12
160	0.00	0.00	0.00	0.00
171	<b>11.64</b>	<b>16.10</b>	0.00	0.00
172	7.88	1.30	0.00	0.04
173	0.04	0.05	0.48	0.10
174	<b>4.57</b>	<b>19.19</b>	<b>5.51</b>	<b>5.26</b>
175	1.84	1.48	0.00	0.00
176	0.00	0.00	0.04	0.13
177	<b>3.43</b>	<b>18.34</b>	<b>2.99</b>	<b>17.62</b>
181	0.37	0.02	0.00	0.00
182	0.59	3.30	0.69	1.31
183	0.00	0.00	0.08	1.25
191	3.83	0.10	0.00	0.00
192	2.54	15.31	0.00	0.00
193	0.73	1.02	1.63	1.86
201	<b>8.70</b>	<b>10.09</b>	<b>2.73</b>	<b>4.55</b>
202	0.00	0.00	0.00	0.00
203	0.67	0.90	0.16	0.26
204	0.03	0.03	9.19	4.88
205	0.72	0.47	0.10	0.17
211	0.00	0.00	1.20	5.59
212	0.36	5.60	1.59	3.10
221	3.31	5.12	5.73	1.25
222	0.89	7.97	0.69	1.97
223	<b>4.65</b>	<b>7.38</b>	<b>12.98</b>	<b>12.33</b>
232	0.00	0.00	0.00	0.00
241	<b>6.49</b>	<b>12.65</b>	0.74	3.39
242	0.00	0.00	0.00	0.00
243	0.01	0.11	0.08	0.12

Sector (NACE 3-digit groups)	1998 State output (sales)/total output (sales) *100	1998 State employ- ment/total employ- ment *100	2001 State output (sales)/total output (sales) *100	2001 State employ- ment/total employ- ment *100
244	0.01	0.06	0.00	0.00
245	0.01	0.00	0.00	0.00
246	0.55	3.46	0.10	0.00
247	0.00	0.00	0.00	0.00
251	0.03	0.00	0.03	0.09
252	0.14	0.28	0.23	0.22
261	0.01	0.02	0.02	0.12
262	0.03	0.11	0.04	0.07
263	0.06	0.13	0.00	0.00
264	0.16	0.93	0.06	0.49
265	0.00	0.00	0.00	0.00
266	0.12	0.16	0.81	2.19
267	0.00	0.68	0.43	0.10
268	0.00	0.20	0.00	0.00
271	0.00	0.00	0.00	0.00
272	0.00	0.00	0.00	0.00
273	<b>22.95</b>	<b>38.08</b>	<b>34.96</b>	<b>10.93</b>
274	<b>19.58</b>	<b>19.84</b>	0.00	0.00
275	0.03	0.35	0.17	0.00
281	3.40	2.55	0.43	0.27
282	0.06	0.05	0.13	0.43
283	0.07	0.07	9.31	6.28
284	<b>16.36</b>	<b>13.74</b>	<b>10.91</b>	<b>11.17</b>
285	0.51	0.52	2.92	1.09
286	4.82	6.77	3.31	4.73
287	0.50	0.43	0.10	0.16
291	4.24	4.79	2.87	4.77
292	1.69	2.36	1.28	0.27
293	0.83	1.36	2.11	0.97
294	0.01	0.17	0.08	0.07
295	1.70	2.85	0.61	0.59
296	<b>98.19</b>	<b>96.04</b>	<b>45.73</b>	<b>57.12</b>
297	0.00	0.00	0.00	0.00
300	0.01	0.02	0.06	0.00
311	0.58	0.89	0.31	0.23
312	0.04	0.05	0.05	0.02
313	0.00	0.00	0.00	2.67
314	0.03	0.00	0.00	0.00
315	0.00	0.03	0.01	0.01
316	0.02	0.07	0.01	0.03
321	0.49	1.48	0.28	0.01
322	1.28	2.90	0.39	3.19
323	0.05	0.17	0.00	0.03
331	<b>6.27</b>	<b>8.82</b>	<b>4.97</b>	<b>5.22</b>
332	0.19	0.24	<b>5.81</b>	<b>6.01</b>
333	0.06	0.12	0.00	0.05
334	0.00	0.00	0.00	0.00
335	0.00	0.00	0.00	0.00
341	0.00	0.02	0.00	0.00
342	0.00	0.00	0.00	0.00
343	0.00	0.03	0.00	0.00
351	0.00	0.30	0.00	0.00
352	2.80	4.97	<b>12.45</b>	<b>16.07</b>

Sector (NACE 3-digit groups)	1998 State output (sales)/total output (sales) *100	1998 State employ- ment/total employ- ment *100	2001 State output (sales)/total output (sales) *100	2001 State employ- ment/total employ- ment *100
353	0.00	0.00	0.00	0.00
354	0.00	0.00	<b>6.56</b>	<b>30.48</b>
355	0.00	0.00	<b>50.43</b>	<b>53.74</b>
361	0.65	0.53	0.31	0.47
362	0.27	0.95	<b>23.41</b>	<b>5.14</b>
363	0.01	0.00	0.00	0.00
364	0.00	0.00	0.00	0.00
365	0.03	0.07	0.42	0.26
366	<b>4.47</b>	<b>25.93</b>	<b>4.15</b>	<b>6.84</b>

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