



## **Product Market Competition and Economic Performance in Hungary**

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*Publication date:*  
2004

*Document Version*  
Publisher's PDF, also known as Version of record

[Link to publication](#)

*Citation for published version (APA):*  
Gjersem, C., Hemmings, P., & Reindl, A. (2004). Product Market Competition and Economic Performance in Hungary. (ECONOMICS DEPARTMENT WORKING PAPERS (ECO/WKP); Vol. 4, No. 381). Organisation for Economic Co-Operation and Development.

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**ECO/WKP(2004)4**



Organisation de Coopération et de Développement Economiques  
Organisation for Economic Co-operation and Development

**02-Mar-2004**

**English - Or. English**

**ECONOMICS DEPARTMENT**

**ECO/WKP(2004)4**  
**Unclassified**

**PRODUCT MARKET COMPETITION AND ECONOMIC PERFORMANCE IN HUNGARY**

**ECONOMICS DEPARTMENT WORKING PAPERS NO. 381**

by  
**Carl Gjersem, Philip Hemmings and Andreas Reindl**

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**JT00159175**

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## ABSTRACT/RESUMÉ

## PRODUCT MARKET COMPETITION AND ECONOMIC PERFORMANCE IN HUNGARY

The establishment of competitive markets has been one of the cornerstones Hungarian economic policy over the past decade, alongside a successful strategy of attracting foreign investment. Broad statistical measures show no signs of endemically weak domestic competition, though the country's relatively low productivity among domestic business likely signals some sheltering from international competition. The generally healthy level of competition is partly because competition legislation and its enforcement are of a good standard. Nevertheless, room for improvement is suggested in a number of areas. In particular, it is argued that individuals should be able to initiate legal actions directly, *i.e.* without having to proceed via the competition authority. And, it is suggested that sanctions against individuals in hard-core cartel cases are introduced. In examining specific sectors, this paper is critical of the pace of progress towards competition in the network industries. The rail network, for instance remains fully state-owned and run. And, problems remain in those industries which have been privatised and opened up to competition. In particular there are instances of continued regulation of consumer prices as well as state ownership or influence on other aspects of supply chains which contributes to a dominance of incumbent providers. Concern is also expressed about competition levels in some other areas of the economy. In particular, professional associations are judged as often having some rules and regulations that excessively limit competition and it is concluded that on EU membership, the size and structure of agricultural subsidies may not induce rapid restructuring. This paper is part of the OECD's 2004 economic survey for Hungary and is one of a series of reviews on competition issues across OECD Member countries.

*JEL Classification:* K21, K23, F13, O47, O52, O57

*Keywords:* Hungary, competition, antitrust law, competition legislation, regulated industries, regulatory reform, protection, aggregate productivity and growth

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## CONCURRENCE SUR LES MARCHES DE PRODUITS ET PERFORMANCE ECONOMIQUE EN HONGRIE

La mise en place de marchés concurrentiels a été l'une des pierres angulaires de la politique économique menée par la Hongrie au cours de la dernière décennie, parallèlement à des mesures qui ont permis d'attirer l'investissement étranger. Bien que les indicateurs statistiques généraux ne mettent pas en évidence d'insuffisance systématique de la concurrence sur le marché intérieur, la productivité relativement faible des entreprises locales témoigne probablement d'une certaine protection vis-à-vis de la concurrence internationale. Le niveau généralement soutenu de la concurrence tient en partie à la qualité de la réglementation en matière de concurrence et de son application. Néanmoins, des améliorations seraient sans doute possibles dans plusieurs domaines. En particulier, il semblerait souhaitable que les particuliers puissent engager directement des actions en justice, sans avoir à passer par l'autorité de la concurrence. De même, il serait probablement utile que des sanctions puissent être prises à l'encontre des particuliers dans les affaires d'ententes injustifiables. Examinant différents secteurs, le rapport juge insuffisante l'ouverture à la concurrence dans les industries de réseau. Le réseau ferroviaire, par exemple, appartient encore intégralement à l'État et est exploité par lui. Par ailleurs, des problèmes subsistent dans les activités qui ont été privatisées et ouvertes à la concurrence. En particulier, les prix à la consommation sont encore réglementés dans certains cas, tandis que l'État reste présent ou exerce son influence dans d'autres domaines des chaînes de production, ce qui contribue à donner une position dominante aux opérateurs historiques. Le niveau de la concurrence dans certains autres domaines de l'économie est également jugé insuffisant. Il semblerait notamment que les associations professionnelles appliquent souvent des règles et réglementations qui limitent la concurrence de façon excessive, et il est à craindre que lors de l'adhésion à l'UE, l'ampleur et la structure des aides en faveur de l'agriculture ne favorisent pas une restructuration rapide du secteur. Ce rapport fait partie de l'Étude économique de l'OCDE de 2004 sur la Hongrie et s'inscrit dans le contexte d'une série d'examen consacrés aux questions de concurrence dans les pays de l'OCDE.

*Classification JEL :* K21, K23, F13, O47, O52, O57

*Mots Clefs :* Hongrie, concurrence, législation antitrust, législation en matière de concurrence, secteurs réglementés, réforme de la réglementation, protection, productivité globale et croissance

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## PRODUCT MARKET COMPETITION AND ECONOMIC PERFORMANCE IN HUNGARY

by

Carl Gjersem, Philip Hemmings and Andreas Reindl<sup>1</sup>

### Introduction

The establishment of competitive markets has been one of the cornerstones of Hungary's structural policy over the past decade, alongside a successful policy of attracting foreign investment in some sectors. In terms of privatisation, competition law, sector-specific regulation, subsidies and public procurement, the approach to competition in many respects now differs little from many OECD countries. However, certain sectors of the economy inevitably get left behind in the wake of such rapid structural change. Hungary has effectively developed a two-speed economy. On the one hand it has a highly competitive and technologically advanced export sector, largely foreign-owned and run. On the other hand it has a large number of relatively small-scale, low productivity domestically owned manufacturing and service industries that have been less exposed to competition in the course of the transition process. Also, in terms of network industries, significant efforts are still needed to create competitive markets in electricity, gas and telecommunications and the process of liberalisation in rail and postal services has barely begun. With much of the policy work to fulfil EU-accession guidelines over, policy-makers can now focus their attention on some of the fundamental issues the country needs to address to ensure its living standards continue to catch-up to those of leading OECD countries.

This paper starts out with a short review of the key features of Hungary's product markets and estimates of the potential macroeconomic impact of further regulatory reform. This is followed by an evaluation of competition legislation and its enforcement and a sector-by-sector analysis of regulatory policy. The final section provides policy recommendations.

### Key features of Hungary's product markets

#### *Assessment of transition*

Prior to the collapse of the Soviet Union, Hungary had a relatively market-based production system compared with other eastern bloc countries. Early on, steps had been taken to introduce some market-type mechanisms in the enterprise sector, even though production facilities were state-owned and governed by central planning. Furthermore, much of the economy was generally isolated from world markets because trade was principally with the COMECON countries. Since the collapse of the Soviet Union and the transformation of the political system, Hungary has made considerable advances in market-based production. State-enterprises in manufacturing and services have largely been sold off and operate in

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1. This paper appeared initially as a chapter in the 2004 *OECD Survey of Hungary*. Carl Gjersem (formerly with the OECD Economics Department) is now at the Norwegian Ministry of Finance, Philip Hemmings is head of the Hungary desk in the OECD Economics Department and Andreas Reindl works on competition law issues in the OECD's Directorate for Financial and Enterprise Affairs. The authors would like to thank members of the OECD's EDRC committee for comments on the paper as well as those of colleagues and the Hungarian authorities. Special thanks are due to Marianna Lehmann at the Hungarian Ministry of Finance, Carolina Guerra for statistical assistance and Caroline Abettan, Sheila McNally and Susan Gascard for help in putting the document together.

regular markets. For the network industries, the initial steps have been taken to open them up to competition. In many aspects of policy, including competition, Hungary is now comparable to most other OECD countries. And, its economy has experienced a period of strong growth and continues to catch up with other member countries (**Table 1**).

Table 1. **Output, employment and productivity**

1990-2000 average in international comparison

	Hungary <sup>1</sup>	Austria	France	United Kingdom	United States	Japan
<i>Decomposition of growth</i>						
Average GDP growth	2.3	2.5	1.9	2.2	3.1	1.8
<i>of which:</i>						
Productivity	4.2	2.1	1.3	1.8	1.7	1.3
Employment	-1.9	0.4	0.7	0.4	1.3	0.5
<i>of which:</i>						
Unemployment <sup>2</sup>	-0.4	-0.1	0.0	0.1	0.1	-0.2
Work force	-1.5	0.5	0.7	0.3	1.2	0.7
Demographics <sup>3</sup>		0.3	1.0	0.4	1.0	1.1
Participation rates <sup>4</sup>		0.2	-0.3	-0.2	0.2	-0.4
<i>Labour productivity growth in selected industries</i>						
Manufacturing	4.6	4.2	3.5	2.4	3.8	2.3
Electricity, gas and water	2.5	2.9	3.9	8.5	2.5	2.6
Construction	1.7	2.3	-0.4	2.5	0.1	-1.9
Distribution, hotels and restaurants	1.4	1.1	0.7	1.4	3.2	1.4
Transport and communication	5.3	2.1	3.0	4.3	2.8	0.6
<i>Memorandum items:</i>						
MFP growth <sup>5</sup>		1.5	1.1	1.0	1.3	2.3
GDP per capita <sup>6</sup>	37	78	74	72	100	75
GDP per hour worked <sup>6</sup>	27	102	109	85	100	76

1. 1992-2000

2. A positive sign indicates that unemployment has declined and contributed to boost output growth.

3. The contribution from demographics comprises changes in the size and age composition of the working age.

4. Measures the effect from changes in age specific participation rates.

5. Business sector.

6. 2001 levels. PPP-based. United States = 100.

Source: OECD, Eurostat.

### **Standard competition indicators**

A number of broad indicators of competition levels are used in international comparisons. It should be stressed that these measures are relatively crude and open to alternative interpretations. For instance price-cost margins may be misleading because price setting ability stemming from market power may be accompanied by rent dissipation resulting in normal mark-ups, but high input factor remuneration. Nevertheless, when taken together such indicators may convey useful insights or point to areas where

further analysis is warranted.<sup>2</sup> In the case of Hungary none of the indicators suggest the level of competition is endemically weaker than in other OECD countries:

- Estimated price-cost margins are not significantly above the average of other OECD countries in most industries (**Figure 1**), giving no signal of widespread monopoly rents.<sup>3</sup> However, there are caveats. For instance the mark-ups in electricity, gas and water supply are more likely not reflecting intense competition but government intervention that keeps retail prices low to households.
- Concentration indices are generally low, reflecting the small size of enterprises. Exceptions lie in the sectors dominated by high exposure to foreign direct investment or where former state-owned enterprises still dominate. There is however some indication that there may be barriers to entry for small and medium-sized enterprises as new-firm establishment rates are comparatively low.
- Export intensity and import penetration are among the highest in the OECD (Nicoletti *et al.*, 2003), even in industry-by-industry comparisons (**Table 2**), suggesting that, overall, Hungary is not protecting domestic industry from competition. While re-exporting activities may be providing a generous view of trade exposure, Hungary's generally liberal policy stance on trade suggests there is no major issue in this quarter. For example, Hungary has today no parallel import restrictions under its "international exhaustion" import regime.<sup>4</sup>
- Another indicator of competitive pressure is the relative aggregate price level with respect to other countries. With appropriate adjustment for GDP per capita, such comparisons do not suggest any particular cause for concern.<sup>5</sup> Indeed Hungary, along with other transition countries (such as Poland, Slovakia and the Czech Republic), has relatively low prices, even allowing for its low purchasing power (*i.e.* it is positioned below the regression line in **Figure 2**). However, such price differences may also be driven, for example, by differences in indirect taxes and unmeasured quality differences in goods and services.

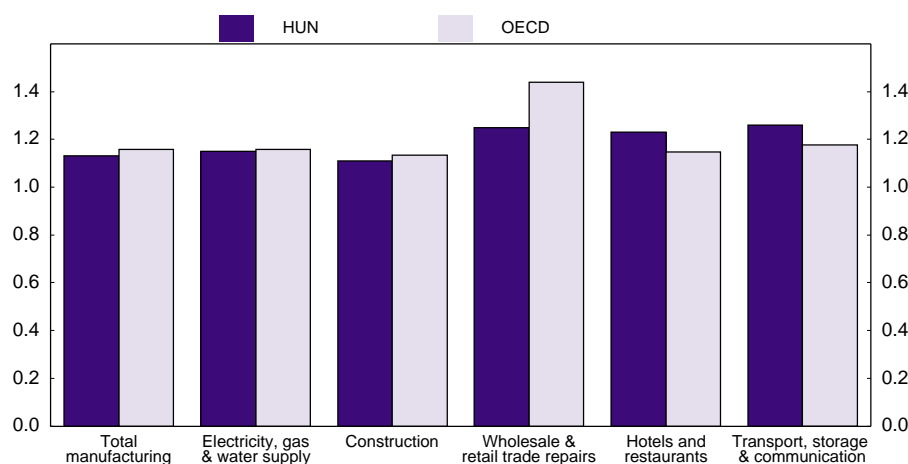
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2. See the OECD's framework paper on competition issues for further discussion on competition indicators, OECD (2002).

3. Comparisons of mark-ups across industries are potentially affected by differences in the treatment of sunk costs. In some cases they are included in the total cost, in others not (see Oliveira Martins *et al.*, 2002 for more detail).

4. Under a national exhaustion regime, parallel importing is prohibited. In contrast, parallel importing is in principle unregulated in jurisdictions applying an international exhaustion regime. Community (or regional) exhaustion is the intermediate case, where parallel importing is allowed between the countries that make up the community but prohibited from countries outside it.

5. Adjustment for GDP per capita is made because of a tendency for higher service-sector prices in high-income countries. For example, wages in low-productivity service sectors may be determined by wages in high-productivity manufacturing sectors, resulting in relatively high prices for services. Since the relative demand for services tends to rise with per capita income, higher income countries will tend to have systematically higher price levels than lower income countries.

Figure 1. Mark-ups by industry sector<sup>1</sup>

1. Estimated sectoral mark-ups from 1981 to latest available year. For Hungary the period is 1991-2000.
2. Data refer to Belgium, Canada, Finland, France, Germany, Italy, Japan, Netherlands, United Kingdom and Australia.

Source: OECD (2003) STAN database.

Standard indicators of long-run capacity to develop competitive domestic producers (and maintain international competition) through R&D activity suggest that there is perhaps room for improvement. Total R&D spending — at 0.8 per cent of GDP — is clearly below the OECD average and Hungary remains one of the lowest ranking countries in terms of R&D activity in the OECD (OECD, 2003a). Private R&D still only represented 0.3 per cent of GDP in 2000 compared to 1.4 per cent in the OECD overall. In the manufacturing sector, the R&D gap is partly explained by the comparatively small high-tech sector and the high number of small and medium-sized enterprises. Given that there is plenty of room for further catch-up through the import of technology, a very weak level of domestic R&D activity may not be a problem. However, it may be so if low R&D reflects inadequate efforts to engage in research that adapts imported technologies and techniques to Hungarian production and market conditions. Indeed, international evidence does suggest a strong positive link between domestic R&D effort and the capacity to successfully adapt technological innovations from abroad.

Although Hungary is quite strongly specialised in the production of ICT goods, domestic penetration of ICT technology is low. In 2000, value added in the ICT sector represented more than 10 per cent of business-sector value added, placing Hungary among the top ten OECD countries in this regard. Multinational companies cover 70 per cent of the internal IT service market, but larger Hungarian-owned firms and innovative SME's are also prominent. However, fixed telephony penetration and internet penetration is lagging behind other OECD countries, while mobile penetration is very high (more than 70 per cent). The internet penetration rate has been particularly low, partly due to the relative cost of computers and partly due to access costs. However, internet penetration is now on the rise. At the same time, other indicators of ITC are more encouraging. A Financial Times (2001) study based on OECD data examining the capacity of countries to develop knowledge-intensive economies ranked Hungary 6<sup>th</sup> out of the OECD countries. The government's commitment to IT resulted in 2002 in the creation of a separate Ministry of IT and Telecommunications. It has already implemented a number of policies aimed, *inter alia*, at increasing internet awareness and increasing internet penetration, particularly broadband



Table 2. **Import penetration in manufacturing**Imports as a percentage of the sum of production and imports, latest year of data available<sup>1</sup>

	ISIC Rev.3 code	Hungary	Euro area <sup>2</sup>		United States	Japan
			Total	Excluding intra-zone imports		
<b>Total manufacturing</b>	15-37	42	29	17	20	9
<b>Segmented, high R&amp;D</b>		46	38	23	28	9
Chemicals and chemical products	24	51	36	19	17	9
<i>of which: Pharmaceuticals</i>	2 423	..	..	..	16	8
Office, accounting and computing machinery	30	46	74	66	47	21
Electrical machinery and apparatus, nec <sup>3</sup>	31	35	29	18	35	9
Radio, television and communication equipment	32	59	48	39	31	11
Motor vehicles, trailers and semi-trailers	34	39	31	13	32	3
Other transport equipment	35-351	..	..	..	19	28
<b>Fragmented, high R&amp;D</b>		61	30	19	23	9
Medical, precision and optical instruments	33	62	42	32	18	30
Machinery and equipment, nec <sup>3</sup>	29	65	28	16	21	5
Furniture; manufacturing, nec <sup>3</sup>	36	45	28	20	35	8
<b>Segmented, low R&amp;D</b>		24	24	12	11	9
Coke, refined petroleum products and nuclear fuel	23	13	22	12	17	11
Basic metals	27	44	36	21	20	7
Building and repair of ships and boats	351	..	..	..	6	1
Rubber and plastic products	25	48	24	11	11	3
Food products, beverages and tobacco	15-16	10	18	7	6	10
<b>Fragmented, low R&amp;D</b>		41	21	12	15	10
Textiles	17	63	32	19	25	29
Wearing apparel, dressing and dying of fur	18	33	39	32	51	26
Leather, leather products and footwear	19	64	37	26	73	51
Wood and products of wood and cork	20	31	19	12	12	24
Pulp, paper and paper products	21	52	28	14	10	5
Printing and publishing	22	17	8	3	2	2
Other non-metallic mineral products	26	30	13	5	13	4
Fabricated metal products except machinery and equipment	28	39	13	6	8	3

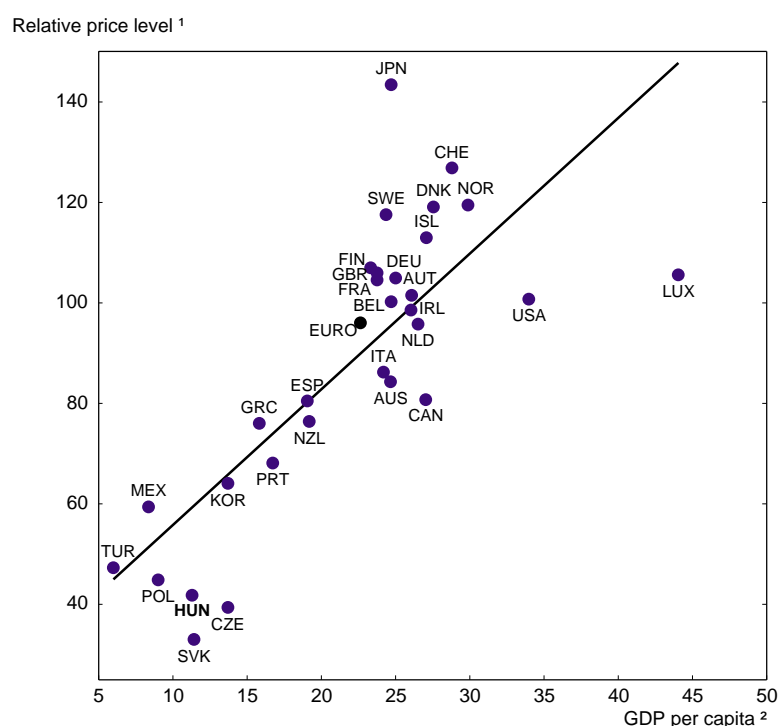
1. 2000 for Hungary, the euro area and Japan, 2001 for the United States.

2. Calculated using 1999 data for Portugal, and excluding Ireland and Luxembourg.

3. Nec: not elsewhere classified.

Source: OECD, STAN and ITCS databases and OECD calculations.

Figure 2. **Relative price levels and GDP per capita in OECD countries**  
1999



1. Purchasing power parities (PPPs) divided by the exchange rate, OECD = 100.

2. In thousand USD, converted using PPPs.

Source: OECD.

### ***The FDI sector***

Hungary's strong economic growth from the mid-1990s has been fuelled mainly by the development of an FDI-funded, export-based manufacturing sector with a focus on component production and assembly for EU-based production chains. Annual industrial production rose through the 1990s, taking the share of manufacturing in gross output above 40 per cent by 2000.

Inward FDI is generally viewed as bringing positive benefits: it exposes domestic firms in the same line of business to new competition, acts as a catalyst for new technologies and techniques to diffuse through the economy, and strengthens international linkages and market access. The precise mechanisms and magnitude of these benefits for Hungary are difficult to gauge. Given that foreign firms do not typically compete in the same product markets as domestic firms, FDI does not have a large direct impact on competition.<sup>6</sup> Rather, foreign firms are likely to induce improvements in competition indirectly. For example, outsourcing to Hungarian firms by foreign firms is likely to encourage domestic competition.

6. Interestingly, Schoors and Van der Tol (2002) find that while domestic producers specialising in exports tend to have responded positively to FDI-based competition, those selling in the domestic market tend to be negatively affected by the presence of FDI-based competitors, suggesting that the latter are unprepared for foreign competitors and easily lose market share.

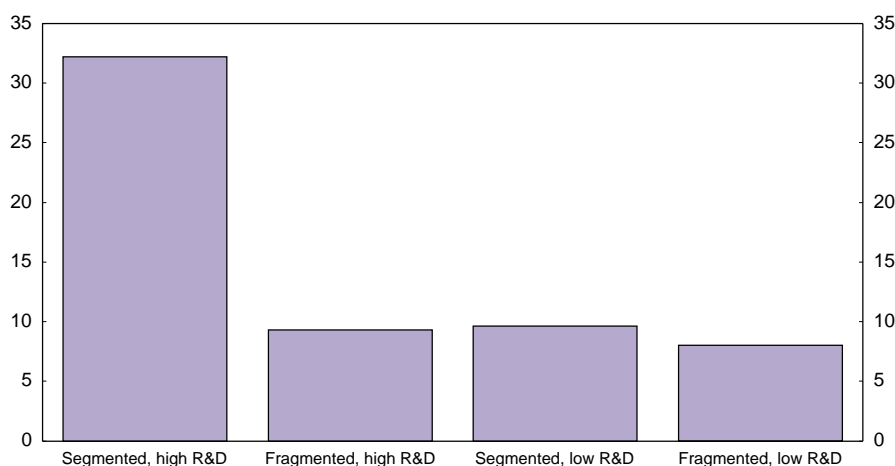
And evidence suggests that there are more complex spill-over effects at work.<sup>7</sup> Nevertheless, the range of these effects from FDI is limited to certain sectors, and regions, notably the western part of the country.<sup>8</sup>

Given recent trends of slowing FDI to Hungary, the pace of such spillovers may slow down. At the same time, however, there may be further potential spillover from existing FDI enterprises. And spillover in technology and “know-how” comes not only from FDI. Accession to the European Union, in particular, is likely to ensure that Hungary deepens its economic links with other countries. However, given that the transmission of technology and “know-how” is not automatic, the authorities should be vigilant to assure that domestic policies are as conducive as possible to such dynamic catch-up processes.

### *The domestic sector*

The limited integration of Hungarian firms into the FDI production chain has contributed to large parts of the economy remaining in something of an economic backwater. A broad indication of this is the wide regional and sectoral dispersion in GDP per capita. Also, productivity growth in some service sectors (where FDI typically is not present) is low. For instance there was roughly 1½ per cent productivity growth in the distribution, hotel and restaurant sector, a rate roughly similar, for instance to the United Kingdom (**Table 1**). At this pace catch-up in productivity to levels in other countries would appear at best slow. Also, mark-ups in the service industries are significantly higher than those in manufacturing where FDI is concentrated (**Figure 1**). The contrast between FDI and domestic production is also seen in **Figure 3** where the “segmented, high R&D” sector which is largely foreign-owned has much higher productivity than other categories of manufacturing industry.

Figure 3. **Average labour productivity**  
Per cent average annual growth, 1991-2000



Source: OECD (2003) STAN database.

7. For instance, Schoors and van der Tol (2002) find that quality enhancements among local input suppliers to FDI-based firms seem to affect other users of these inputs positively.
8. Based upon a large database of Hungarian enterprises, Sgard (2001) finds that productivity spillovers are much stronger in the north-western part of country (between Budapest and the EU border) than elsewhere. The paper also finds that foreign and Hungarian firms share the same volume of externalities in the north-western region whilst elsewhere the benefits are reduced by 30 per cent for foreign firms and appear to be very low for Hungarian firms.

Small-sized firms are another indication of the poor development of domestic Hungarian business. For example, over 60 per cent of firms are sole proprietors, compared with an EU average of 50 per cent and only 0.7 per cent of firms have more than 50 employees compared with 0.8 per cent in the European Union (Ministry of Economy and Transport, 2002). Statistics show that the enterprise creation rate in 1995-1998 was among the lowest of the CEC-10 countries, but has since picked up (Eurostat, 2002).

The authorities have recognised the need for better performance among domestic businesses. Some measures aimed at this issue were included in the *Szechenyi* Plan which included subsidies to enterprises and more recently the 'Smart Hungary' programme also supports Hungarian business. However, direct subsidies that shelter firms from competitive pressure are hardly the way to go to boost performance sustainably. To-date the financial aid in these packages has not been strongly linked to performance, being generally in the form of direct subsidies. There are also moves underway to increase the use of subsidised credit arrangements. The authorities should evaluate carefully whether this is an effective way to foster firms that will be competitive in the long run.

### ***Infrastructure***

Despite recent investment, the transport system remains sub-optimal. Notably, the fragmented and low-density highway network may hinder the development of markets, limiting opportunities and thus reducing competitive pressure. This may be particularly the case in retailing where a low density of high-speed road links may allow local market power to persist. International assessments echo the concern about infrastructure. For example OECD work ranks Hungary's infrastructure very low in international comparison (Nicoletti *et al.*, 2003). Also, the European Commission reports transport infrastructure in the whole central-European region is in a much worse situation than in western Europe, particularly in remote rural areas (European Commission, 2000). Even regional road networks planned for the future will have a lower density than in western Europe. Particularly important for the Hungarian regions is good transport connections to Budapest, which itself has good links with the rest of Europe. In this regard, the south-western and north-eastern regions are poorly served, although this problem should be reduced on the completion of the first elements of the recent road construction programme.

### ***Gauging the potential impact of reform***

Although the channels through which regulatory reform affects economic performance are complex, calculations can be made that at least provide a rough indication of the impact of reform. **Annex 1** shows the results of a simple exercise based on assumptions about the quantitative economic impact of reforms on price-cost margins, productive efficiency and performance. In this exercise, capital efficiency gains are assumed to be very small in transport and postal services because the need for investment will probably offset any efficiency gains in existing capital. The calculations are based on a re-alignment of practice with international norms and not with best practice, and are in this sense conservative. Following this approach Annex 4.1 presents estimates of the effects of reforms in network industries, distribution, professional and community services. The estimates suggest that regulatory reform in these sectors could increase aggregate labour productivity by 6-7 per cent and reduce producer prices by some 4-6 per cent. Competition legislation and its enforcement

OECD assessment of Hungary's competition legislation and enforcement has in the past generally been positive, underscoring that many features of the relevant law and its application compare favourably with other OECD countries. And, the authorities have proved to be open to explore areas of possible further improvements. It nevertheless appears necessary to investigate how far procedural and organisational changes can be implemented so as to free resources and improve the competition authority's ability to prioritise and increase the effectiveness of competition law enforcement.

***Structure and institutional setting***

Hungary's competition legislation is executed by an independent antitrust authority, the Gazdasági Versenyhivatal (GVH).<sup>9</sup> Independence in judging competition cases is reinforced by a strict separation between the decision making body (the Competition Council, *Versenytanács*) and investigative functions.<sup>10</sup> In 2002, the Competition Council took a decision in 174 competition supervision proceedings and fines were imposed in 33 cases. The GVH's resources are generally regarded as adequate.<sup>11</sup> However, European Union membership, including notably the move to decentralized enforcement of EU competition law, may entail additional workload. Decisions of the Competition Council can be appealed through the judicial system, the Metropolitan Court in Budapest, and from there to the Supreme Court. The appeal process can be long, and sometimes takes several years. Appropriate measures to further accelerate the appeals process should be considered.<sup>12</sup> Nevertheless about 50 per cent of competition law infringements are appealed, suggesting that oversight of the GVH appears to be effective in the parties' views.<sup>13</sup> In 2002, only three decisions were overruled by the Court while imposed fines were reduced on five occasions. In five further cases the Court annulled the decision and ordered new competition supervision proceedings.

In addition to regular enforcement of competition issues, the GVH also investigates certain cases of consumer fraud (which in 2002 represented nearly one-third of the case-related work-load). A representative of the GVH is a member of the Public Procurement Council.<sup>14</sup> In addition, co-operation between the GVH and regulatory authorities (Hungarian Energy Office, Communications Authority, Communication Arbitration Committee and Hungarian Financial Supervisory Authority) has been institutionalised. There has been discussion that the GVH's work on consumer fraud cases should be transferred to another government agency so it can focus more on competition law enforcement.<sup>15</sup> However, on balance, the GVH's expertise in certain areas suggests that this work should remain part of its remit.<sup>16</sup> Also, it should be noted that several other OECD member countries appear to successfully combine both consumer protection and competition law enforcement in the competition authority. If consumer fraud work indeed remains in the GVH there might be efficiency gains if a separate sub-unit

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9. The GVH it is not subject to government instructions, and reports only to the Parliament.
  10. The investigating sections of the GVH are responsible inter alia for: the investigation of complaints, decisions whether to initiate cases, case file preparation, the submission of a report to the Competition Council, and compliance review. Decisions are adopted by the Competition Council (which by law has full independence within the GVH) after a trial-type public procedure, although the trial may be omitted if all parties consent.
  11. The GVH's staff has slightly increased in the recent past and currently consists of approximately 120 employees. Compared with similarly situated countries in the region, the number of employees is about the same in the Czech Republic and but half the size in the Slovak Republic.
  12. OECD (2003b), p.6. and OECD (2001) p. 187.
  13. Courts in the first and second instance reversed several decisions by the Competition Council in 2002, reduced fines in others, and remanded other cases for further proceedings to the GVH (GVH, 2003, p. 5). The launch of appeal procedures used to entail the suspension of decisions on fines, thus adding incentive to appeal. Since the reforms in 2001, however, decisions imposing fines are immediately effective.
  14. The Public Procurement Council is independent of the GVH.
  15. See, e.g., OECD (2001) p. 184 and p. 204.
  16. As in competition law, consumer fraud can be unlawful only if it has an "effect on competition". Another agency with no experience in the enforcement of general competition law might more willing to adopt a softer approach and apply the law in situations where competitors complain about aggressive business practices, but no harm to competition can be found.

were to be created. This would permit greater specialization of investigators and enable them to better focus on developments in their respective areas.

### ***Key features of the competition legislation framework***

#### *Substantive law*

Hungary's substantive competition law, which was established in 1984 with major revisions in 1990 and 1996, generally closely follows current European Union competition law rules. It might be advisable, however, to change certain aspects concerning the rules on restrictive agreements to avoid ambiguity when European Union rules will be changed in 2004.<sup>17</sup> The GVH considers that cartel activities are a problem in Hungary and has paid particular attention to this area. Revisions in 2001 aimed in particular at strengthening rules and enforcement tools concerning hard-core cartels. The GVH's means to investigate suspected cartels was strengthened, in particular through the possibility of dawn raids. In addition, prior to the 2001 amendments, *all* agreements were exempted from the Competition Act if the parties' combined market share did not exceed 10 per cent. This statutory exception has been removed for agreements among competitors that include hard core restrictions.

#### *Coverage*

Although the Competition Act in principle applies to all sectors of the economy, it can be overridden by other statutes, some of which are difficult to justify on economic grounds. There has been a welcome reduction in the scope of the Price Regulation Act which now only applies to a few areas such as utility and transport prices. But in other some other areas, notably in pharmaceutical products, statutes prevent price competition on the retail level. Regulations limiting the effectiveness of competition law continue to be pervasive in the liberal professions although the GVH has had some success in increasing competition in this area. For example, it successfully challenged the practice that 'recommended minimum fees' for medical services were in effect obligatory prices.<sup>18</sup> The GVH has also been critical of a recent law that prohibits retailers from selling certain agricultural products below cost.<sup>19</sup> There are areas where enforcement of the Competition Act has not been very effective, notably in cable-TV services which are

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17. Following EU demands during the accession process, Hungarian legislation provides that provisions in agreements that appreciably restrict competition are prohibited and unenforceable, unless exempted by way of individual decision following notification, or by compliance with the terms of a block exemption. The EU's approach to restrictive agreements, however, will change in 2004. Agreements will be valid and enforceable, unless the Commission, a court, or a competition authority finds the contrary. The possibility of obtaining individual exemptions following notification will be abolished. To maximize harmonization between the two systems and minimize disputes as to which of the two systems applies to a specific agreement, it appears advisable that Hungary follows the example of other EU Member States and consider implementing the same changes in Hungarian competition law.
18. Hungary's EU membership may facilitate the GVH's task in these types of cases. To the extent that certain practices are shielded from the application of competition law by Hungarian statutes and regulations, the GVH would be able to apply EC competition law to challenge practices that restrict competition and are capable of affecting intra-Community trade.
19. The GVH opposed the law on retail agricultural produce prices because of its anticompetitive effects. It also considered the law unnecessary because, despite increased concentration on the retail level, there was no evidence that the level of concentration already had reached levels that could have negative effects on competition (see main text on the retail sector). Even though it opposed the law, the GVH has indicated that its enforcement practice concerning vertical restraints will in the future focus on buyer power and the economic effects of restraints imposed on suppliers. It has emphasized, however, that enforcement action would be justified only in cases where buyer power actually has harmful effects on competition, and not in those where the size of a company worries a competitor or supplier.

the subject of by far the largest number of complaints of abuse-of-dominance. Investigating these complaints absorbs considerable resources but there have only been a few successful cases, primarily because it is very difficult to establish “abusive” (excessive) prices.<sup>20</sup> This situation might be improved by the application of the new Electronic Communications Act (due to come into force on 1 January 2004). The Act implements the European Union Universal Service directive and will include tools based on EU guidelines for *ex-ante* supervision and regulation of retail telecommunications markets. If cable-TV services can be interpreted as retail telecommunications markets, then the ‘significant market power’ (SMP) concept could be applied to them. In this way the Act could therefore strengthen the GVH's ability to control cable-TV services providers *ex post* for potential abuses of their dominant position. However, a final decision has yet to be reached in consultation with the European Commission as to whether cable-TV can be considered as retail markets for the purposes of the act.<sup>21</sup> At the same time, the authorities should also take a broad look as to why competition is weak in this area and whether there are areas of regulation that inhibit the development of robust competition for the delivery of programming and other use of these networks. For instance, it appears that satellite-TV is unable to provide strong competition to cable-TV, notably due to the low level of local content.

It should be noted that the GVH has the power to challenge anti-competitive decisions of other administrative agencies in court. This instrument has been used only once (the GVH successfully brought a case when a municipality denied a taxi licence for an entrepreneur who was not a local resident), but the mere threat of its use has been effective in several cases. Examples include the GVH's intervention when a municipality promised a retail chain that it would not issue new construction and establishment permits to the retail chain's competitors, and when another municipality which was a popular tourist venue tried to prevent entry of a new service provider who intended to operate an electric tourist train.<sup>22</sup>

### *Enforcement*

There have been positive developments in the area of enforcement. In 2001, the GVH created a specialized cartel unit and obtained new investigative powers.<sup>23</sup> As part of the increased cartel enforcement, the GVH is developing a leniency policy which is expected to closely follow European Union guidelines. Also, the level of fines has increased significantly. Fines up to value of 10 percent of a firm's annual revenues can now be levied and conform to European standards. Total fines imposed were up by 600 per cent from 2001 to 2002 (not taking into account the results of appeals proceedings). This is regarded as reflecting the end of a 12-year long “transition period,” during which the GVH was willing to treat competition law infringements leniently to allow firms to adapt to the new legal requirements. However, the absence of a well documented fining policy based on objective factors that could be

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20. Moreover, in the long term it cannot benefit the GVH's standing if there is a group of cases where it consistently fails to solve problems that affect a great number of consumers.
  21. Because the new Telecommunications Act implements a European Union directive, it must be ensured that its interpretation is consistent with Community law.
  22. The GVH can also bring action against acts and regulations before the Constitutional Court and in two cases has successfully used the threat of such an action to prevent anti-competitive measures (preferential customs duty regime for Ford Transit; discriminatory fee by the Hungarian Post for the establishment of newspaper kiosks by new entrants).
  23. The new investigative powers of the cartel unit include the right to conduct dawn raids to secure incriminating evidence, investigate private premises of corporate officers, and take oral testimony. This was among the recommendations of the OECD Report (OECD, 2001, p. 189). To ensure that the message about basic principles of competition law as well as effective competition law enforcement reaches all market participants, the new cartel unit has prosecuted several smaller, local cartels, in addition to national cartels. The elimination of the statutory exemption of agreements of minor importance that contain hard core restrictions was another element in the effort to prosecute cartels more aggressively.

reviewed by the courts may also have contributed to the GVH's reluctance to impose stiff fines.<sup>24</sup> Guidelines concerning the GVH's fining policy are being developed. The new, higher fines have not yet been tested in court.

Further instruments of enforcement should be considered, in particular sanctions against individuals. Such sanctions can be highly effective in the deterrence and prosecution of cartels and can also increase the effectiveness of leniency programs. It would have to be ensured, however, that any new sanctions do not interfere with the current framework of enforcement.<sup>25</sup> Also, introducing the right of individual action before national courts to enforce claims based on competition law should be considered.<sup>26</sup> Such private suits would strengthen individuals' rights and might free up enforcement resources for the GVH. It could also reduce unnecessary jurisdictional disputes in the future. In particular, after Hungary's EU accession individual actions before national courts will be possible under EU law. Without parallel facilities in the Hungarian law there will be inevitable jurisdictional difficulties.<sup>27</sup> The current Competition Act gives the GVH an interesting and rather unique enforcement tool in the form of a 6 month suspension of decisions in cases initiated by the GVH. The Competition Council may terminate the proceedings if the infringement has come to an end. This "probation period" is designed to encourage defendants to cease infringements of a minor nature without the need to reach a formal decision. The suspension of proceedings appears to be a well functioning tool, and in 2002 nine cases were terminated in this way.

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24. Drawn-out proceedings in a coffee cartel case may have also made the GVH cautious in its fining policy. In 1994 the GVH imposed a very significant fine of almost HUF 400 million on participants in a coffee cartel. The appeal process in this case has continued for many years and in the latest development the Metropolitan Court ordered that the entire case be re-examined. The GVH has appealed this decision to the Supreme Court.
25. There would be a risk that anti-cartel enforcement could become more difficult if the current system of administrative corporate fines was replaced with sanctions against corporations and individuals that are exclusively based on criminal law, in particular because of higher standards of proof that apply in criminal cases. Various options could be considered to avoid such a risk: first, certain sanctions against individuals could be included in the current enforcement system, thus enabling the competition authority to impose sanctions against corporations and individuals in the same procedure, second, criminal sanctions, including imprisonment, could be introduced in parallel to the current system of corporate sanctions. Such sanctions would have to be enforced by the institutions involved in criminal law enforcement, with a possible supportive/advisory role of the GVH and coordination between the two enforcement systems.
26. At present, individual enforcement of competition law claims before courts is not possible. Nor can courts grant interim relief. Individuals can bring actions for damages resulting from violations of competition law, but must first obtain a decision by the GVH finding an infringement.
27. As of 2004, a private party will be able to assert in a contract dispute before a Hungarian court that restrictions in an agreement are invalid because they infringe EU competition law, provided it can demonstrate that the agreement in question is capable of affecting intra-Community trade (the same principles will apply in cases concerning abuses of a dominant position.). Depending on the facts of the case, the party also might claim damages. In contrast, in the absence of effects on intra-Community trade, only Hungarian law will be applicable to restrictive agreements. Courts will have no jurisdiction to decide the competition aspects of a case, and a plaintiff first will have to obtain a decision by the GVH before it can sue for damages in court. Disputes about jurisdiction appear unavoidable in those circumstances, even though the substantive rules are largely harmonized. The ability of Hungarian courts to treat claims under EU and Hungarian competition laws alike would greatly facilitate enforcement efforts by individuals. If a right of individual action were introduced, giving the GVH the right to appear before Hungarian courts in an advisory role ("amicus curiae") should be considered to ensure consistent application and development of Hungarian competition law.



*Procedures*

Some aspects of competition-law procedure require attention. Despite some reforms in 2001, there is room for further improvement in the review period for merger cases. For example relatively simple cases are taking about two months to resolve.<sup>28</sup> The 2001 reforms also tried to make merger review proceedings more efficient. In particular, they allowed preliminary contact between the investigator and the Competition Council to enable the latter to provide initial guidance.<sup>29</sup> This reform, however, is not regarded as having hastened the review process and further possibilities should be explored. For example, case handlers could be required (within, say three weeks) to submit a preliminary report recommending whether a case should be cleared or pursued further. The Council could then be required to make a decision on the basis of this recommendation within a short period of time.<sup>30</sup> A revision of the notification thresholds should also be considered so as to reduce the number of notifications and expedite the review of remaining notifications.<sup>31</sup>

In other areas, greater flexibility in the application of review periods appears desirable. At present, an initial 180-day deadline applies in cartel investigations which can be extended twice by 180 days. The total review time has so far been sufficient for cartel investigations. While strict deadlines are generally in the public interest, this is generally not the case for cartels (where investigations can take a long time, especially in the international cases). Hence, current deadlines should be extended or, even better, eliminated.<sup>32</sup> In other areas, procedural rules are excessively hampering flexibility. In particular, fulfilling the 60 day limit for decisions on individual complaints adds to the already considerable cost of this area of the GVH's work. Extending the review period for such complaints would at least allow better prioritization of case loads. A more effective measure would be to increase the GVH's discretion to open a full investigation following a complaint. Any concerns that such reform would limit the ability of individuals to seek remedies when they are harmed by anti-competitive conduct could be met by introducing the right of individuals to bring a private action before courts as discussed above.

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28. The Competition Act initially provided for a set of firm, and generally rather short review periods. The 2001 reforms introduce some changes, but the current experience suggests that the mix of different review periods could still be improved. The Act currently allows for a 45 day review period which can be extended by 60 days for cases that do clearly not raise competitive issues. However, the average review period for these cases was 57 days in 2002. This suggests that several relatively simple cases were decided after a review period that exceeded two months. This is long by international standards. The International Competition Network (ICN) recently adopted Recommended Practices for Merger Notification Procedures that address review periods. The Best Practices suggest that the review of cases that do not raise material concerns should be concluded within six weeks or less. In many other European jurisdictions, the first phase review must be completed within one month or thirty days. While the statutory deadlines in Hungary are reasonably close to the ICN's suggested review periods, the review periods are considerably longer in practice.

29. GVH (2001), p. 22.

30. A more radical solution would be to give investigators the power to terminate merger review procedures after (say) a one month review period if the case raises no material concerns, without need to obtain a decision by the Council. This power could be modified by requiring a decision by the Competition Council if the investigator and the parties have agreed on a remedy to resolve competition concerns during the initial review period.

31. Hungary has not revised its notification thresholds since the current Competition Act was adopted in 1996 which suggests that today the thresholds capture a larger number of small transactions than was intended when the thresholds were initially adopted. See GVH (2001), p. 14.

32. For example, investigations of international cartels by the European Commission typically take several years before the Commission is available to issue a decision.

## Regulatory policy

Hungary has gone a long way in the process of privatisation and reform towards best-practice market regulation. In many areas privatisation is completed or nearly so. And the privatisation program has picked up again after a slowdown in 2002. The state-owned Privatisation and Holding Corporation (APV), which had stakes in 167 businesses in December 2002, has seen its portfolio reduced to 157 in December 2003. Also, the classification of some units as “strategic” and not for sale has been dramatically reduced, from 93 companies to 23 in 2003. In the network industries, the state’s shares are being steadily reduced. For example the state’s share in the gas supplier and distributor, Magyar Olaj-és Gázipari Rt (MOL) is down to 22.7 per cent and the sale of a 13 to 17 per cent stake is currently under way. These moves are in line with recommendations made in the 2002 OECD *Survey* of Hungary.

However, there are key areas where progress in reform has been slow. Incumbents have remained dominant in the reformed network industries, while some other network industries (notably rail transport) have not yet undergone any significant reform and remain as wholly state-run enterprises. In non-network sectors, there is debate about the impact on competition of large retail chains and certain retail sectors remain possibly over-regulated, such as pharmaceuticals. Also, as in other countries in the region, some of the rules and regulations of professional bodies seriously limit effective competition. EU accession has already initiated relaxation of some these constraints, and ongoing expansion of European law on the recognition of professional qualifications will erode them further.

The direction of some reforms is also disturbing. In particular, steps have been taken towards ensuring authorities have legal tools for cost-based price control, rather than measures to promote market-based prices. In a liberalised market, high prices relative to costs should be allowed to result in entry of new firms and/or expansion of supply, and low prices to reduce supply. While some access and interconnection prices may have to be regulated (such as third party access to networks), the authorities should be careful about regulating end user prices and should favour market solutions.

As in many other policy areas, ensuring conformity with European Union regulations is guiding many of the competition policy measures. In the case of network industries, regulation needs to conform to the European Union’s *acquis communautaire* (**Box 1**), which has resulted in much of Hungarian regulation in the network industries being based upon blueprints from Brussels. While there are some outstanding issues with regard to the *acquis*, with accession nearly complete the authorities will increasingly have resources for further adjustment and refinement of regulation to provide the best framework for competition given Hungary’s economic environment.

### *Selected network industries*

Hungary has made reasonable progress in privatising and the first steps in liberalising the electricity, gas and telecommunications markets. This has been achieved by the same broad strategy implemented in many other OECD countries: progressive selling-off of state shares, establishment of regulatory authorities; separation of the ownership and operation of the “network” component of the industry (which is generally a natural monopoly); opening up of supply and distribution to new entrants; and deregulation of pricing. As elsewhere, there are a number of trade-offs in deciding on how to schedule privatisation and liberalisation processes. For instance governments have often to take into consideration that moves towards greater competition for incumbents are likely to reduce privatisation cash revenues.

**Box 1. The role of the *acquis communautaire* in network industry regulation**

The *acquis communautaire* is the set of European Union laws and practices that the European Union accession countries have to adopt, implement and enforce. For the negotiations prior to accession, *the acquis* was divided into several chapters and, where accession countries have difficulties, transition periods and exemptions are allowed. Negotiations on the chapter on competition were opened in 1999. The Chapter is based on EC Treaty Article 31 (State monopolies of a commercial character), Articles 81-85 (Rules applicable to undertakings), Article 86 (Public undertakings and undertakings with special or exclusive rights) and Articles 87-89 (Rules applicable to State aid). Through the negotiations, the European Union requested the following:

- commitments to be mirrored in actual domestic legislation,
- evidence of an adequate administrative capacity to implement the commitments, and
- a record of day-to-day enforcement with a high degree of similarity with current enforcement practice in the European Union.

In addition, there are safeguards such as participation in the European Union-wide network of competition authorities and guidelines from the Community authorities. Agreement on the 31 chapters of the *acquis* was closed for all candidate countries by December 2002. The state and progress in each of the candidate countries are assessed in the European Commission's "Regular Report" (European Commission, 2002). The final issue of this report appeared in October 2003.

Both the telecommunications and the postal sectors are subject to the general competition rules contained in Chapter 19 of the *acquis*. For telecommunications, conforming to the Chapter has involved the introduction in 2002 of additional elements to the major revision of the sector that was made in 1999 and in 2003 a new act on telecommunication aiming at full transposition of the 2002 *acquis* was adopted by parliament. The "Regular Report" of 2003 assesses that while the necessary administrative structures are in place, the role and the regulatory capacity of the Communications Authority need to be strengthened along with the capacity for economic analysis. For postal services, the *acquis* has prompted a policy of gradual liberalisation, with the objective of eventually opening up to an EU-wide single market for postal services within a regulatory framework that ensures a universal service. For this, candidate countries need to: adopt a national postal development policy consistent with Community policy; prepare market players for the pressure of competition when they join the Union; and transpose and implement Community legislation. In the 2003 "Regular Report", the European Commission concluded that some legislative alignment remained to be completed in postal services. For electricity and gas, the Energy Chapter requires the candidate countries to decide on an overall energy policy with clear timetables for restructuring the sector, including preparations for the internal energy market. In addition, measures on crisis handling, consequences of restructuring of mines, energy efficiency and diversification and nuclear power plant issues are included. The 2003 "Regular Report" assessed that considerable progress had been made through the adoption of the electricity law, which will pave the way for the liberalisation of the Hungarian market. Similar progress was made in the gas sector with the adoption of the new Gas Act in June 2003.

Rail transport is covered by the Chapter on the transport sector. The *acquis* in this Chapter is based on Articles 70-80 of the EC Treaty. Hungary has a number of reform plans including gradual phasing in of access to the Hungarian rail market and complete access by 31 December 2006.\* In its 2003 "Regular report" the European Commission advised that transposition of the *acquis* is taking place according to schedule, with some additional restructuring needed for full implementation. In addition, the report underscores that institution-building efforts have to be further enhanced in this sector.

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\* Other transitional arrangements in transport are related to road networks and aircraft traffic.

However some steps have not been successful in certain important respects, and there is room for further reform. In broad terms, there has been reluctance by the authorities to relinquish control. In particular:

- The state has retained strong rights to intervene in the activities of the network regulators. The most prominent example is retail price setting for gas and electricity where the government has the final word on pricing decisions. As a result, pricing has often been influenced more by political than by economic motives.
- The state has maintained strong influence in the incumbents' activities and allowed them to remain as significant or even dominant players in many network markets. For instance, the state retains special rights in its remaining shareholdings. These "golden" shares include veto rights over capital decreases, changing shareholders' or ownership rights, and special rights of representation. For the oil and gas company, MOL, the State has special rights in issues related to so-called "strategic" interests. In September 2003, the Economic Cabinet judged that compliance with EU legislation did not require the abolition of these arrangements, though changes in detail would be required.
- Only few steps towards reform have been taken in some network industries. Notably, rail and postal services have remained as entirely state-owned enterprises with overstaffing problems and inefficient infrastructure.

### *Electricity*

In the electricity sector, Hungary has begun price liberalisation (see **Figure 4** for an international comparison of prices).<sup>33</sup> The Electricity Act (passed in December 2001) allows for gradual opening of the market by giving large customers the option (but not the obligation) to go outside the regulated area from 2003 on. Prices will, however, continue to be regulated (they are based on costs and are below market prices) for small users (principally households) for longer. The option for large customers will cover 30 to 35 per cent of the market in 2003. In line with the relevant EU Directive, Hungary is dedicated to liberalize the electricity market in 1 July 2004 for all consumers except households, for whom market will be liberalized in July 2007. Thus, progress at ending household-price subsidisation looks set to be slow and will be further hampered by the maintenance of the option to buy at the regulated price level. This approach is partly due to obligations that ensure security of supply and the protection of captive consumers. Preferably, such welfare concerns should be resolved *via* general transfer arrangements rather than through these price regulations. Furthermore, with rising living standards, justification for maintaining low retail prices in these activities on the basis of welfare is weakened and the authorities should look towards making households face the true market prices (IEA, 2003); this would also help achieving environmental objectives.

The government is also influential in determining network access charges for new entrants to the electricity market ("third party" access charges). A greater degree of independence of the regulatory institutions would help in this area, as it would limit the influence of government pricing and also that of business interests (so-called "regulatory capture"). The only partial privatisation of the incumbent, Magyar Villamos Művek Rt. (MVM), has also slowed the liberalisation process. Furthermore, the six distribution companies that are responsible for network operation and supply of electricity to end-users have exclusive supply areas. And, ownership is concentrated among some of the large well-known European energy companies (EDF, E.On, and RWE).

Good progress has been made in installing a separate transmission operator and there are now competing providers in generation and distribution. While electricity transmission is very much a natural

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33. The government is able to influence prices because although the sector regulator, the Energy Office (MEH) calculates and proposes prices, the final decision is made by government (the Ministry of Economy and Transport).

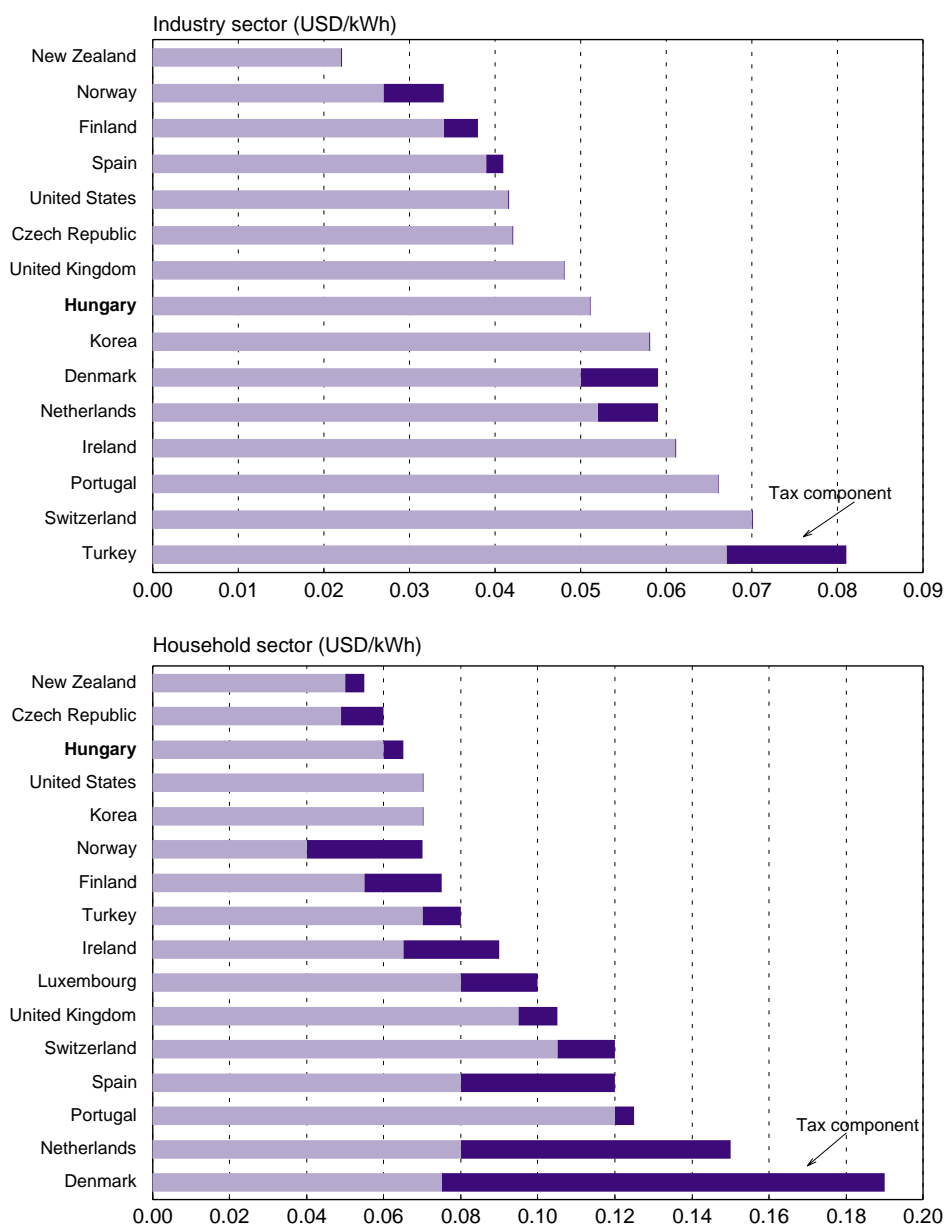
monopoly, generation and distribution are potentially competitive areas. Thus an industry structure that promotes competition needs to dismantle certain types of vertical integration. In particular effective separation of transmission from the other activities is required to avoid cross-subsidisation. International experience indicates that accounting separation does not suffice, pointing to the need for legal or ownership unbundling. Legal unbundling was introduced in the 2001 Electricity Act. Similarly, for small-scale customers to benefit from liberalisation, retailing and distribution activities should be separated out. While in 2000 there was virtually no such separation, there were thirteen generation companies, one transmission company and six distribution companies in 2003. The operation of the grid is carried out by a public company (MAVIR), while the network itself is still owned by MVM (IEA, 2003). The ownership of the grid (and previous experience of operating) almost certainly gives MVM some degree of competitive advantage in distribution activities, as it has a greater understanding of the system and possibly greater means to influence the grid operator. MAVIR's responsibilities in the management and operation of the physical network should be strengthened along with the arrangements for monitoring the cross-border transmission network capacity. Current international connections are approaching capacity and the authorities should look for options to establish new lines and upgrade the existing ones. This may also contribute to increasing competition. The authorities should facilitate MAVIR's role and arrangements for monitoring the cross-border transmission network capacity.

Steps have finally been taken to prevent long-term contracts signed prior to liberalisation from stifling the development of the electricity market. Since they fix generation companies' prices and quantities, such long-term supply contracts with distributors limit the available supply and demand and thus restrict competition and the development of the market. This issue was raised during the development of the new Electricity Act but was deemed less important than the necessity to uphold the existing contracts. However, recently some measures have been taken to force the incumbent (MVM) to auction off some of its contracts, leading in June 2003 to the sale of its excess supply capacity for the second half of 2003 to six electricity-trading companies.<sup>34</sup> Further to this encouraging development, long-term contracts should be followed closely and more measures should be considered if necessary.

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34. For this auction, MVM set up an 85 MW "Virtual Power Plant" and auctioned the 85 MW of capacity, or the 375 GWh of electricity it could produce. Electricity purchased at the auction cannot be exported directly or indirectly. The starting price was Ft 7/kWh and deals were struck around Ft 8/kWh.

Figure 4. International comparison of electricity prices, 2001



Source: IEA (2003).

### Gas services

The development of competitive markets in gas services faces a number of problems, and is a particularly crucial issue as it is an important energy source in Hungary. One problem is a lack of supply possibilities. Hungary's capacity for domestic production is limited and approximately three quarters of the gas consumed is imported from the Russian supplier GAZPROM. The structure of the international pipeline network combined with engineering limitations means that there is little prospect in the near future

of competition between international suppliers (IEA, 2003). Furthermore, state-ownership in the dominant supplier, MOL, is still substantial, and the government has, at times, covered a significant part of MOL's losses through *ad hoc* payments. Indeed, the previous government backtracked on the privatisation of gas. However the new government is back on course and the political discussion is focused on when the next tranche of MOL will be sold. In September 2003, MOL initiated the examination of the possibilities and consequences of the sale of its gas business.

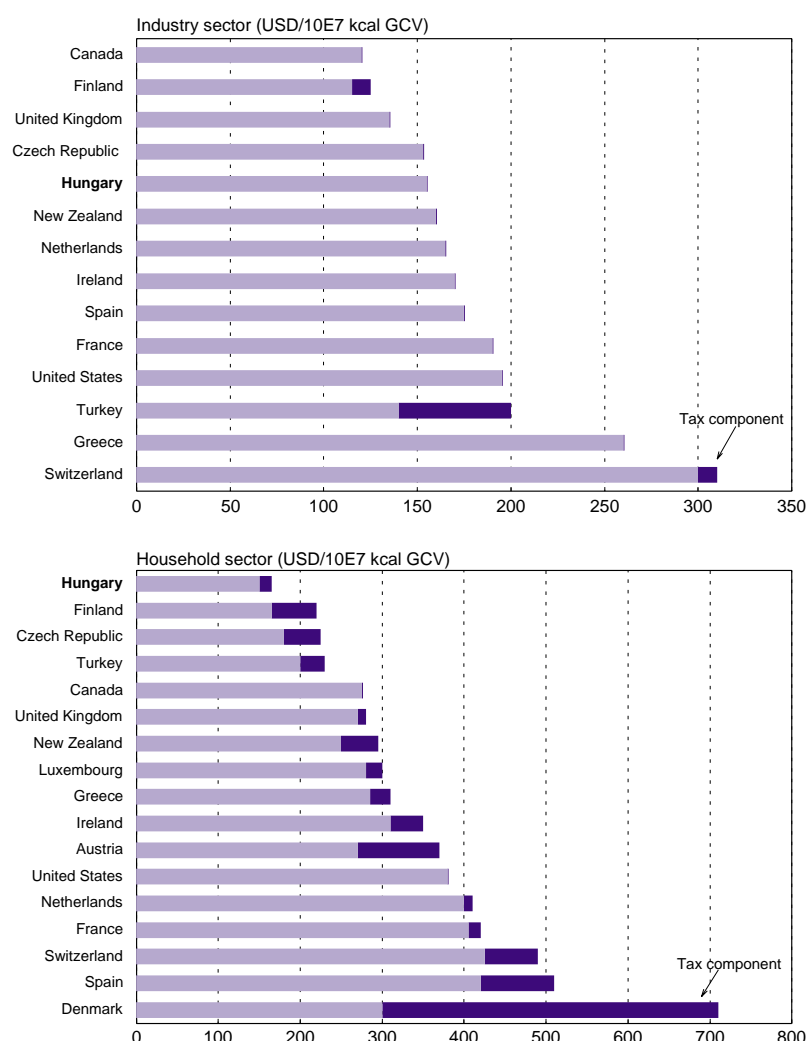
In a welcome move, a partial liberalisation of gas pricing is scheduled (see **Figure 5** for an international comparison of prices). This has been partly prompted by the conclusion of the European Commission that alignment with the membership *acquis* in this regard has not been completed, and that legislative needs in this area need to be urgently addressed (European Commission, 2002). At present gas prices to all consumers are regulated through a system introduced in July 2002. The Energy Office proposes prices annually, based on "expected price developments and according to the principles of asset and cost-based pricing" (*op. cit.*). However, as in the electricity sector, the government plays a decisive role in price-setting, sometimes overriding pre-agreed formulas if the resulting price increases are deemed too large. New legislation, passed in June 2003, schedules an opening of a market to large consumers from January 2004 and all non-domestic consumers from July 2004.

The issue of cross-subsidisation has been tackled by stronger enforcement of separation between production, transmission and distribution functions. There are now several companies operating in the distribution market. However, there remains ground for concern about vertical integration, as MOL, the dominant gas supplier to distributors, itself operates as a distributor. MOL now supplies imported and domestically produced gas at regulated wholesale prices to six gas distribution companies, which sell to end-users at regulated prices. Unfortunately, competition between these distribution companies is likely to be diminished because of ownership structures: a handful of major European operators are key shareholders (with complex cross ownership) in five of the six gas distribution companies, along with MOL.<sup>35</sup> Hungary also has, along with many other European countries, a problem of ensuring that entrants have access to pipelines and storage facilities. The authorities should set up conditions that facilitate the decision by MOL and other companies to install additional gas storage facilities, *inter alia* by allowing tariffs to reflect storage costs (IEA, 2003).

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35. Out of the six companies, GdF has a majority in two (DÉGÁZ and ÉGÁZ), Ruhrgas and RWE own one together (DDGÁZ) while RWE has also holds large parts of the equity of two others (FÖGÁZ and TIGÁZ, which is dominated by Italgas). The remaining company (KÖGÁZ) is dominated by E.ON Hungariá and EVN. MOL owns around a third of DÉGÁZ and ÉGÁZ.

Figure 5. International comparison of gas prices, 2001



Source: IEA (2003).

### Telecommunications

With technological progress making greater competition increasingly feasible in the domestic and international telephony markets, many governments are encouraging such competition to develop. Independent regulatory agencies have been established with a mandate to open markets to competition, prevent incumbents from abusing their position and avoid collusion between operators. In Hungary, gradual liberalisation started with the amendment of the 1992 Telecommunications Law, but its pace has not been satisfactory. The main fixed line telecommunication market was opened in December 2001 with some temporary exceptions, notably delay in the expiry of local telephone concessions to 2002.<sup>36</sup> In the

36. In its 1997 Opinion, the Commission concluded that Hungary should have little difficulty in adopting the EU model of telecommunications liberalisation in the medium term because it had already implemented most of the *acquis*. It added that if foreign investment continued at its current pace and if a tariff-rebalancing scheme was introduced, the sector should be able to face full competition.



run-up to EU membership, the Commission has stressed that Hungary should focus on ensuring an affordable universal service and on continuing the enforcement of the regulatory framework for telecommunications (**Box 1**). Modernisation of the fixed network is complete, but market penetration has peaked at a low level.<sup>37</sup> In contrast, the mobile network market has several players and high penetration. It has been acknowledged that the Telecommunication Act of 2001 is ripe for replacement and new EU-compliant legislation will be implemented from 1<sup>st</sup> January 2004.

One reason why the telecoms-sector reforms have not been very successful is because the incumbent operator, MATAV, is a significant, and often dominant, player in many of Hungary's telecommunications markets. MATAV was privatised in 1994 and is owned in majority (just below 60 per cent) by Deutsche Telekom. The monopoly of MATAV expired on 23 December 2001, and a number of large international players have since entered the Hungarian telecommunications markets (*e.g.* BT, Pantel, Vivendi). Nevertheless, MATAV remains an important, and sometimes dominant, player in certain activities. And, as mentioned above, the share retained by the government entails some considerable preferential rights. MATAV dominates the fixed telephony market. In particular, it is the dominant player in international telephony services and in long-distance domestic services. Though the regional operators also operate in national markets (including internet services and data communication services) their focus is on operating local networks. In addition, some foreign competitors in fixed-line markets pulled out from the Hungarian market, though market shares have generally passed on to other international service providers. MATAV is also the market leader in the mobile telephony market through its subsidiary Westel, although the two other mobile service providers together now have a market share over 50 per cent.

MATAV's strong position partly reflects a tilting of regulations against new entrants. Indeed, an international index of restrictions on domestic telecoms distributors developed for the Australian Productivity Commission (Findlay and Warren, 2000) suggests that the Hungarian regulatory regime to be (at least at the time of analysis) far more restrictive for domestic operators than in the European Union, where it is itself more restrictive than in the United States and Japan. For foreign distributors the study scores Hungary as even more restrictive than for domestic operators, and again markedly more than in the European Union, the United States and Japan (where the scores do not differ markedly between domestic and foreign providers).<sup>38</sup> The legislative changes since this analysis are likely to have improved some aspects of the outlook on the Hungarian regulatory regime. Nevertheless, recent OECD work (Golub, 2003) finds that restrictions in fixed-line services continue to be much higher than in the mobile telephony sector in Hungary, and higher than in most other OECD countries. Also, the dominant fixed-line network operator seems to be able to restrict end users' ability to choose the services of other operators, including alternative internet services. To-date, third party access to the fixed-line network has been granted through individual approvals based on cost-based assessments, and this system is to be augmented by a ministry-based negotiation committee.<sup>39</sup> The authorities should consider evaluating other

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37. About 40 per cent of the population and about 70 per cent of households subscribe to fixed telephony services. The number of mobile subscribers reached nearly 8 million by autumn 2003, implying a penetration rate exceeding 70 per cent. About 15 per cent of households are estimated to be internet subscribers.

38. The index of restrictiveness on telecoms companies summarises the nature and extent of restrictions on establishment and on ongoing operations. Scores range from 0 to 1, with greater stringency of a restriction raising the score. Among domestic operators the study scored Hungary at 0.28, the euro area at 0.15, the United States at 0.03 and Japan at 0.04. For foreign operators the index for Hungary is even higher at 0.53, against 0.26 in the euro area. In the United States and Japan the index does not differ between domestic and foreign providers.

39. Fixed-line approvals for new entrants were based on a fully distributed cost methodology in 2002 and from 2003 onwards on a long-run incremental cost methodology. Legislation to provide a cost-based system for calling mobile phones to fixed-line phones and vice-versa is under way.

arrangements as other countries seem to be moving away from this approach. Notably all EU-15 countries have abandoned negotiated access for regulated access (OECD, 2003c).

Actions that facilitate the liberalisation of telecoms markets have often been late-coming and steps have often been incremental, mainly because of terms of exclusive rights given in concession contracts made at the time of privatisation but also because of technical and market considerations.<sup>40</sup> For these, and other reasons, progress in some key aspects of telecoms markets has been limited. In particular, number portability was approved by the Act of 2001, but not implemented until January 2004 in the fixed-line segment and will be implemented in May 2004 for the mobile segment. In addition, carrier pre-selection has been given legislative backing but its market appears underdeveloped.<sup>41</sup> To-date, access charges and interconnection fees have remained relatively high, with the latter resulting in price squeezes on new entrants and helping the incumbent retain market share.<sup>42,43</sup> Unbundled access to the local loop is provided by law, but is not used in practice, partly because of price squeezes. One factor holding back progress in these areas is that even though there is a close working relationship between the telecommunications regulator (the Communications Authority), the Ministry of Telecommunication and the Competition Office, the regulator's powers seem to have been both weak and too carefully used. The new Telecommunication Act will increase powers of the regulatory authority. In particular these powers include the possibility to apply sanctions against operators that are hampering the process of number portability and carrier selection. The new Telecommunications Act also includes measures aimed at reducing price-squeezing.

However, not all of the poor record of new entry into the fixed-line markets should be blamed on regulation. At the end of the 1990s, rapid double-digit market growth was widely projected worldwide but these expectations have since proved over-optimistic. Partly as a result of this, borrowing has been excessive in telecommunication companies. Investment was cut sharply back after 2000, but the restructuring of the telecommunication sector worldwide is now well underway (Lenain and Paltridge, 2003).

In purchasing-power-parity terms, telecommunications services are expensive relative to other countries (**Table 3**), notably mobile services (especially for high volume users) (OECD, 2003c), though this is partly because some costs (*e.g.* equipment) are independent from purchasing-power-parity terms. The seemingly weak price competition in telecommunications is affecting internet penetration which is about 18 per cent. The Hungarian central statistical office (KSH), estimates there were about 70 internet service providers servicing some ½ million subscribers at the end of March 2003, most of them using dial-up connections rather than broadband cables, though use of the latter is increasing rapidly. By autumn 2003 about one thirds of all internet connections were broadband. The penetration rate is also influenced by a low rate of

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40. Exclusive rights were included in the first wave of the privatization process in 1993 and 1994. The exclusive rights expired in December 2001 for MATAV, and November 2002 for local telephone operators.

41. One of the targets missed by the current Telecom Law was the stipulation that number portability in the fixed-line segment should be in place by January 1, 2003. In July 2003, the cabinet approved a proposal by the IT and Telecommunications Ministry for a decree on number portability.

42. Before 2002 user tariffs and interconnection fees had been controlled by the State and as such they had not been subject for competition legislation and competition authority. The Act of 2002 liberalized interconnection fees, however, because of market externalities, only a gradual price decrease can be achieved by a series of regulatory measures.

43. If the margin between the consumer tariff that the incumbent is charging and the interconnection tariff (procurement cost) that other providers have to pay, is too low, the new entrants cannot offer their services profitably. This is referred to as a price squeeze.

computer ownership. However, increased computer and internet awareness and use are goals for the current government, and a number of policy measures are being implemented, such as tax rebates to companies who invest a minimum of HUF 100 million into broadband internet services and are profit-making at the same time. MATAV, which is set to spend some HUF 7.6 billion in the coming years and thus is the only company that comply with these requirements, will thus be entitled to deduct up almost HUF 3.2 billion from its taxes. An additional HUF 1.3 billion is available for other companies to support the development of broadband internet as well as measures to encourage households to purchase computers.

Table 3. **Telecommunication prices in Hungary**

Based on an OECD basket<sup>1</sup> of telephone charges and measured in a common currency (USD) and in Purchasing Power Parities (PPP)

	Prices compared to: <sup>2</sup>		Ranking <sup>3</sup>	Prices compared to: <sup>2</sup>		Ranking <sup>3</sup>
	euro area (USD)	US (USD)		euro area (PPP)	US (PPP)	
Measured in Residential	0.89	0.79	11	1.51	1.66	28
Business	0.84	0.76	11	1.02	1.24	26
Composite residential*	1.03	0.88	21	1.76	1.84	26
Composite business*	1.08	0.94	19	1.85	1.95	25

1. Composite baskets include international calls and calls to mobiles.

2. Ratio of prices in Hungary compared with either euro area or United States.

3. Ranking reflects the position within the OECD in 2002; a high ranking number indicates a relatively high price.

Source: *OECD Economic Communication Outlook* (2003).

Hungary should encourage new telecommunications technologies and the development of markets given the widening possibilities of competition through competing networks in this sector. The government should press ahead with providing appropriate regulatory environment for additional new technologies, such as Universal Mobile Telephone System (UMTS), or 3G networks.<sup>44</sup> In a welcome move, draft plans for sale of licences have recently been presented, though services could be offered at the earliest some 18 months after tenders are submitted. The authorities should consider introducing transferability in radio-spectrum licenses, as this would facilitate market entry, spur competition and speed up the launching of this new type of network (Lenain and Paltridge, 2003).

#### *Rail services*

In rail services, Hungary has followed international trends by separating train operation from track infrastructure, though only on an accounting basis. Thus, competing operators have not yet been introduced and rail services are still exclusively provided by the state-owned railway company, MAV (OECD, 2002). The accounting separation of MAV was made in January 2003, with a division of its operations into five independent profit centres (freight services, passenger services, hauling services, rolling stock maintenance, track maintenance, infrastructure management and property management) and a cost centre (financial administration). In contrast, full ownership separation has been carried out in a number of countries while others have presented plans to conduct such a separation. The authorities should take stock of developments in these systems, particularly those that have gone a long way towards privatisation, in planning further steps towards separation and competition. EU accession will force some competition in rail services as Hungary will be obliged to begin opening them to competition.

44. Among the range of new technologies, some such as MMS have already been introduced in Hungary. MMS services were introduced in May 2002.

Reform of the Hungarian rail operator needs to take into account that the current system operates at a loss and that heavy investment is required in both trains and tracks if Hungary is to have a modern network.<sup>45</sup> Currently MAV is accumulating losses and financing operations with government-backed loans, which are compensated on an *ad hoc* basis. This procedure does not guarantee the evolution of transport services which offers the highest value for the money invested. Some countries, where privatisation is not evident as a first best solution, have had good experiences with clearly defined service contracts, including small public-private partnerships for infrastructure.

### *Postal services*

Liberalisation in postal services is proceeding in line with the competition *acquis*, but progress is slow and should be accelerated. Only those services which are permitted by the EU Directive remain in the category reserved for public provision (*i.e.* letters and other paper mail). The Communications Act of December 2001 is also aimed at ensuring universal service funding for postal services. The incumbent operator, *Magyar Posta* (Hungarian Post), which provides universal services and is entitled to the provision of reserved services, has started to introduce a cost-based price system and separate accounts. In its Regular Report (European Commission, 2002), the European Commission assessed the progress to be good, but stressed that Hungary needs to speed up the process in order to complete the transposition and implementation of the *acquis*. Hungary has adopted a new Act on Postal Services in compliance with the relevant 2002 EU Directive. In accordance with the timing prescribed by the directive the Act includes measures for further liberalization taking place in 2006. Hungarian Post will implement home delivery of parcels according to the requirements of the universal postal services till the date of the EU accession.

Rationalisation and outsourcing in the postal network is proceeding slowly. For example, EU-induced reforms do not have to be completed before 2009.<sup>46</sup> In particular, progress in rationalising services in rural areas has been limited. There has been some experimentation with mobile postal services, but attempts to close down post offices serving small communities have been successfully resisted by village councils.<sup>47</sup> The reform process also included measures that strengthen the incumbent: extra grants were provided where its activities were exposed to competition. And, there is still a telegraph service within the postal service, for which termination has long been explored (the main reason for maintaining the telegraph service is that telegrams are recognised as official notification documents besides official letters). Also there are no strongly proactive plans to reduce the workforce in the sector, which currently numbers over 40 000. There are no direct measures envisioned on the staff issue, but an out-placement service is operated and early retirement is used. In addition, technical and organizational developments are foreseen in order to reduce the workforce. There is no direct state aid (as “subsidies are prohibited”) and prices in the universal service area are set by ministerial decree. The plan is for prices to grow to the average for Europe and then to be capped there. The authorities should rather follow the approach taken in other countries, that is, state clearly the aims of the service, calculate the cost of the public service obligation, and then finance it through a fiscal transfer.

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45. Inadequate financing of public service obligations and a sharp reduction of demand and revenues has resulted in a huge backlog of development and maintenance of the national railway company.
46. The latest step taken in the EU was the adoption of the New Postal Directive in June 2002, which liberalises (from January 2003) the delivery of letters weighing more than 100 g (or costing more than three times the price of a standard letter) and all outgoing cross-border mail (except for Member countries that prefer not to), to be followed three years later by letters weighing more than 50 g (or costing more than two and a half times the price of a standard letter). The new Directive sets 1 January 2009 as a possible date for the creation of an internal market for postal services, but this will require later confirmation (or can be changed) by co-decision procedure. See *OECD Economic Survey of the Euro Area* (2003).
47. The Magyar Posta originally planned to close all of its unsuccessful offices in 200 villages with a population of less than 600, but due to pressure from village councils this has been postponed.

### *Competitive industries*

While the broad indicators of competition discussed earlier in this paper do not suggest there is a widespread problem of weak competition, there are inevitably some sectors that generate concerns. In particular, there is ongoing debate about the development of the retail sector. And, as in other countries in the region, widespread and highly regulated professional organisations raise doubts as to the strength of competition in some activities.

#### *Retail distribution*

As in many other countries, there has been debate in Hungary on the economic and social consequences of the development of large retail chains (GHV, 2000). The debate has been prompted by the very rapid development of supermarkets over the 1990s, although the ten largest chains even now only occupy about 20 per cent of the market (40 per cent in the case of foodstuffs) and the number of large shops *per capita* is relatively low (**Table 4**). Hence, despite this rapid development, the market concentration is very low by international standards, and, as yet, there is little reason for concern that the retail market is becoming dominated by a few players (GVH, 2000).<sup>48</sup> Also, operating surpluses have been consistently lower than in neighbouring Austria. Generally there are relatively light retailing regulations in Hungary by international standards. For instance rules on shop-opening hours are liberal, as are the regulatory steps for opening new hypermarkets.

Nevertheless, it is clear that there are political pressures to protect the large number of traditional retailers and suppliers. Recently, proposals for tighter regulation of hypermarket opening hours have been presented. While these were turned down, regulation preventing sales below costs has been introduced for agricultural products. Officially, the policy justification behind this move was the need to protect suppliers such as farms and wholesalers from the strong negotiation position of big customers such as foreign retail chains. In principle, however, this measure also protects traditional retailers because it restricts the capacity of large enterprises for strategic cross-subsidisation to cut out small-scale competitors (through such measures as using agricultural products as “loss leaders”). However, the welfare gains from protecting inefficient retailers are questionable at best. Along with this protective measure, a rule has been introduced, specifying that supplier’s credit in the case of agricultural products cannot exceed 30 days; this might to some extent protect small suppliers, but at the same time constrain rather than support traditional retailers.

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48. The link between concentration and competitive pressure is complex in retail distribution and differs from other industries. Dobson et al. (2001) argues that greater concentration may benefit consumers through lower retail prices owing to increased monopsony power of the retail sector vis-à-vis manufacturing producers with (otherwise) dominant positions. The scope for anti-competitive behaviour is also often limited by the threat of entry and by increasingly mobile consumers.

Table 4. Outlet density in Hungarian retail shopping centres

	Hungary	USA	Europe
Number of inhabitants per centre (thousand)	408	6.3	108
Area of shopping centres <i>per capita</i>	0.03	1.99	0.15
Average area (m <sup>2</sup> )	14 000	12 198	15 673
Share from the turnover of the retail sector (per cent)	7.8	53	14.2
Weekly turnover (USD/m <sup>2</sup> )	110	37	90

Source: GVH, 2000 (Competition, Office Bulletin, No. 3 Office of Economic Competition August, 2000).

Cross-border shopping also raises some issues for the development of retailing. Austrian shoppers are attracted by low-priced food products and traditional Hungarian manufactures, but steady reductions in the price-difference have resulted in a decline in this activity.<sup>49</sup> Cross-border shopping expeditions by Hungarians to Austria has in the past been motivated by a wider variety of products and, in some cases, lower prices (notably in electronics and clothes), partly due to VAT refunds. Since 2002 there has been an increase in the volume of Hungarian shopping in Austria, possibly reflecting exchange rate movements, but also increased purchasing power due to wage increases. However this is unlikely to be a long-term trend, not least because the VAT-exemption will end with EU accession, but also because choice comparable to that in Austria is developing. In general cross-border shopping has probably helped competition in Hungarian retailing, and the levelling of the playing field with the upcoming removal of VAT exemptions will provide a healthier basis for this activity.

Turning to other areas of retail distribution, there would appear to be some room for liberalisation in the wholesale and retail markets for pharmaceutical products. Production, wholesale and retailing of pharmaceuticals is privately owned, but subject to a number of special regulations. The conditions on opening up new pharmacies are particularly strict. For instance, there are fixed limits to the number of pharmacies permitted to operate for a given population.<sup>50</sup> Over-the-counter medications were liberalised in July 2002, but the Ministry of Health continues to set ceilings on wholesale and retail price margins of prescribed and non-prescribed drugs.<sup>51</sup> While the intention of the regulations on margins may have been to protect customers from local monopoly and to lower the cost of medical care, it has in fact often resulted in financial difficulties for pharmacies. This can affect the quality of pharmacy services, particularly in rural areas.

#### *Professional services*

Hungary has a long tradition of official professional bodies, similar to those in neighbouring Austria. And, as elsewhere, some of the rules and regulations of these bodies go beyond objectives such as consumer protection or quality guarantee and are essentially rent-seeking. While regulation in this sector in

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49. The number of Austrians coming to Hungary had decreased by 8 per cent in January 2003 compared with the previous year.
50. Ownership of pharmacies is restricted to limited companies, where all active partners have to be pharmacists (and at least one must hold a "personal right to operate a pharmacy"). Pharmacies must serve at least 5000 inhabitants and may not be closer than 250 meters from another pharmacy in cities and 300 metres in towns.
51. While the ex-manufacturer prices were liberalised, wholesale and retail prices are still matter of regulation; there is a maximum margin of wholesale and retail prices of drugs, and retailers can compete inside this limit. In the case of subsidized pharmaceutical products, part of the price to the retail customer is reimbursed by the Health Care Fund. The prices are negotiated between the National Health Insurance Fund, the Ministry of Finance and the manufacturer. In case of non-reimbursed products, there is only an information obligation by the manufacturer or the importer to the Ministry of Health and Social Affairs.

other countries typically includes some statutory frameworks, in Hungary it contains significant elements of self-regulation. A number of professions organise themselves through chambers either on a legal or voluntary basis, and membership is mandatory (**Table 5**). The chambers keep registers of members, and it is usually necessary to be on the register to act within the profession. In other professions (*e.g.* tax-experts, real-estate salesmen) membership in such associations is voluntary. Codes of conduct are widespread, and there is a proliferation of chambers that often generates restrictive practices among their members, including rules regarding prices and bids for contracts. Some of these codes probably have anti-competitive goals and effects. A reduction in requirements and specifications regarding exams, experience, nationality etc. will take place with EU accession.<sup>52</sup> However, restrictions are set both by decree and by the chambers, and are unlikely to be completely removed.<sup>53</sup> As discussed in the section on competition legislation, the competition authority is very attentive in this area.

Indeed, even organised fee setting is not illegal in all areas due to legislation that overrides competition legislation. The chambers for veterinarians and also security services, set recommended minimum prices for their members, while engineers and architects operate with recommended prices. For the legal professions, such as notaries, bailiffs and some legal experts, there are also fee-setting controls. While regulations may be necessary to ensure quality, they may also have the less desirable effect of eliminating or restricting competition. Price co-ordination is inappropriate, especially when it goes against the intentions in the general competition legislation, and a better balance needs to be struck between the interests served by regulation and the need to ensure competition. To increase competition in these areas, measures should focus on removing exemptions from the competition law and on the forceful application of the law.

### *Other policies affecting competition*

Accession to the European Union alters the landscape of Hungary's structural policies in many ways. In particular, subsidies and state aid (particularly in agriculture) and regulatory mechanisms such as parallel imports will change, sometimes dramatically. Hungary was an early starter on establishing a system for increasing the efficiency of public procurement, especially on making sure that competitive bidding took place. But while procurement as a share of GDP is now very high by international standards, the current system has not succeeded in raising the share of procurement advertised in the market above the average for EU countries.

The overall level of targeted support to industry in the form of tax expenditures and subsidies is high but not exceptional by international standards. However it is quite broad ranging. Tax expenditures have been the main instrument used to attract foreign investment while subsidies and other forms of aid are common for domestic industry. As a result, the landscape of incentives determining what is produced and by whom departs dramatically from the relatively neutral stance implied by the standard corporate tax system. It is difficult to get an overall gauge of the level of targeted support. It appears the level of state-sourced subsidies ("state-aid") is not exceptional by international standards, although there is a need to bring certain aspects of aid policy in line with EU guidelines.<sup>54</sup> Sectoral and *ad hoc* state aid was

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52. The free flow of goods and people across the Europe was one of the bases for the original Rome Treaty. In addition to existing directives, this will also be strengthened by the Directive on the recognition of professional qualifications and the Directive on services in the Internal Market. The Commission's upcoming extension of the screening mechanism for draft national technical legislation to cover services (European Commission, 2003) will also reduce the possibilities of operating national barriers.

53. In some sectors, notably health, there will be full recognition of qualifications and in principle no restrictions to qualified EU nationals working in Hungary.

54. "State-aid" is a term with specific meaning in EU policymaking. Importantly, it comprises subsidies (in the form of grants, subsidised loans etc) that are provided by the state and not by other authorities. For

estimated to represent 0.66 per cent of GDP in 2000, just below the European Union level average of 0.69 per cent (Eurostat structural indicators).

As a consequence of the accession *acquis* and EU rules on state aid, legislative changes became effective in January 2002 that include a general prohibition of state aid with exemptions containing the basic principles of state aid control. The legislation also provides for increased control and monitoring of aid granted by local authorities, since 1 January 2003 the state aid control has applied to the local authorities as well. Staff levels in the State Aid Monitoring Office within the Ministry of Finance have been increased and additional training activities implemented. Despite these reforms the European Commission remains critical, in particular because of Hungary's fiscal aid policy (European Commission, 2002).<sup>55,56</sup> In particular, the Commission argues that increased awareness of the rules on fiscal aid is needed, especially among government aid grantors, the business community and the judiciary. The commission also criticised state aid policy for having legislation that does not allow for full control of fiscal aid and does not include a regional aid map with acceptable maximum aid intensities. An immediate closure of incompatible fiscal aid schemes was required, and a conversion of the "tax holidays" that attracted foreign investors (most of them lasting until 2011) into aid arrangements that are compatible with the *acquis*. A number of measures have been taken towards these goals, including changes in the tax incentives and the development of a regional aid map. The latest assessment by the Commission on state aid concludes that both the implementing structures and enforcement record are generally satisfactory, but underlines the need for further amendments to fiscal legislation regarding individual fiscal benefits to large companies to fulfil the *acquis* (European Commission, 2003a).

#### *Tax expenditures and subsidies*

While much effort is being put into making sure state aid measures conform to EU rules, less attention is being paid to broader questions of cost efficiency and long term impacts. Hungary has state aid schemes, and is receiving aid from the European Union's central funds. It is evident that these funds are not always being used in the best possible way. For example, Phare-supported installation of gas connections to develop tourism in areas was carried out without ensuring that other essential services such as water or electricity services are also available. To make better use of these schemes, it is clearly important to look beyond the formal issues raised by the need to conform to EU legislation and assess their efficiency. Also, there should be more investigation as to whether the policy objectives of state aid could be attained in less costly ways, for example by introducing evaluation procedures.

#### *Agricultural support*

Agriculture remains a significant, though declining, part of the economy and also has a high profile in policy debate. The share of the workforce in agriculture has fallen from 20 per cent in 1985 to a little over 5 per cent, close to the European Union average of 4.4 per cent, while about one third of the population lives in rural areas. The OECD Producer Support Estimate shows the percentage of public support in the

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example, funds provided through the EU's Common Agricultural Policy (CAP) are not counted as state aid. Hungary has already been receiving pre-accession aid from the EU. Over the period 2000-2002, Hungary's annual allocation is € 96 million for Phare, € 38.1 million for SAPARD (agriculture and rural development) and between € 72.8 and 104 million for ISPA (infrastructure: environment and transport).

55. In its 1997 Opinion, the Commission concluded that more needed to be done to achieve the degree of transparency required and that the role and powers of the monitoring authority had to be clearly defined to ensure the compatibility with the Community rules of the aid granted. Furthermore, the Commission noted that a considerable effort would be necessary to fulfil the requirements in the field of state aid over the medium term.
56. Hungary's annual state aid report for 2000 was presented to the European Commission in April 2002.



total value of production at farm gate prices is 24 per cent in Hungary, compared with 35 per cent for the EU and 31 per cent for the OECD. But the share of producer support arising from strongly production-distorting or trade-distorting policies is estimated by the OECD at about 90 per cent in Hungary for 2000-02, compared with about 70 per cent in the European Union.<sup>57</sup> The final agreement on the Common Agricultural Policy (CAP) reached at the end of June 2003 aims to increase de-coupling and cross-compliance, but it contains clauses that allow the maintenance of payments linked to acreage and livestock numbers so that restructuring of Hungarian agriculture might not be rapid.<sup>58</sup> However, this will depend on the attitude of the Hungarian authorities to decoupling. On balance, Hungarian farmers are expected to receive a higher producer price for cereals than before (despite a small reduction in the average intervention price). The authorities have chosen to introduce the CAP's Simplified Area Payment Scheme rather than the classical direct payment scheme. Analysis from the Commission (European Commission, 2003b) suggests that CAP reform will likely secure income gains in the new member States. While farmers' income from market activities is estimated to increase by 17 per cent in real terms between 2002 and 2009, the total real income increase, including direct payments and rural development payments, could be more than 45 per cent.

### *Parallel imports*

Competition in Hungary is enhanced by the absence of restrictions on parallel imports on a global basis.<sup>59</sup> EU membership will, if anything, reduce the discipline that parallel imports bring to markets. Exemptions to parallel imports within the European Union area and parallel import restrictions on non-EU imports, for example *via* the European Union's trade mark law, will apply. While the impact of these restrictions on competition and other aspects of the economy is complex to evaluate, negative effects are likely to be limited as only branded goods are affected.

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57. The OECD's most recent publication on agricultural policies estimates that annual average direct and indirect support for agriculture was 2.7 per cent of GDP in the period 2000-2002 (OECD, 2003, p.243). The calculation of the share of producer support that is strongly distorting is based on the sum of market price support, payments based on output and payments based on input use (see OECD, 2003, p.219).

58. De-coupling involves the separation of payments from specific activities (notably production of food products) and cross-compliance involves the compliance to minimum standard requirements across all areas receiving payments (e.g. production, set-aside, environment). The CAP reform includes a shift towards a single farm payment independent from production, linked to the "respect for environmental, food safety, occupational safety and countryside stewardship". At the same time, countries are allowed to keep part of the support as payments linked to current planted area and livestock numbers. Other aspects of the reform include the reduction of direct payments according to farm size and the establishment of a stronger rural development policy.

59. Parallel imports refers to imports in products which take place outside the official distribution system set up by a particular firm, exploiting the differences of prices in different countries.

Table 5. Regulation of entry and conduct: professional chambers

	Qualification	Experience	Mandatory Association Membership	Membership Fee	Insurance	Further Training Requirements	Restrictions on other Occupational Activities	Legal Authorisation: fee setting controls	Nationality	Residence	Branch Office
Physicians	Higher degree	No	Yes	Yes	No	No	Yes	recommended minimum prices	No	Yes	No
Pharmacists	Higher degree	No	Yes	Yes	Yes	No	Yes	No	No	Yes	No
Lawyers	Higher degree	3 years	Yes	Yes	Yes	No	Yes	No	Yes	Yes	Yes
Notaries	Higher degree	3 years	Yes	Yes	Yes	No	Yes	Yes	Yes	No	Yes
Patent Lawyers	Higher degree	3 years	Yes	Yes	Yes	No	Yes	No	Yes	Yes	Yes
Auditors	Higher degree	3 years	Yes	Yes	Yes	Yes	Yes	No	No	No	No
Engineers	Higher degree	2 or 5 years	Yes	Yes	No	No	Yes	recommended minimum prices	Yes	No	No
Architects	Higher degree	2 or 5 years	Yes	Yes	No	No	Yes	recommended minimum prices	Yes	No	No
Veterinary Surgeons	Higher degree	1 year	Yes	Yes	Yes	Yes	Yes	recommended minimum prices	No	Yes	Yes
Phytochemistry experts	Higher degree	No	Yes	Yes	No	Yes	Yes	No	Yes	No	No
Judicial executors	Intermediate degree	Yes	Yes	Yes	Yes	No	No	Yes	Yes	No	Yes
Judicial experts	Higher or Intermediate	5 or 10 years	Yes	Yes	No	Yes	No	Yes	No	No	No
Security services	Professional exam	No	Yes	Yes	Yes	Yes	Yes	recommended minimum prices	Yes	Yes	Yes

Source: GV.

Table 6. Total expenditure (consumption and investment)

(% of GDP)	Total expenditure (TE)				TE less compensation				TE less compensation. & defence	
	General	Central	Local	Social	General	Central	Local	Social	General	Central
Canada	25.8	4.6	22.3	0.0	11.5	1.7	8.8	0.0	10.4	0.6
United States	19.5	6.9	12.6	0.0	8.8	3.7	5.1		6.2	1.1
Australia	20.0	5.7	14.8	0.0	8.9	2.1	5.8		7.6	0.9
Japan	16.8	3.5	13.0	0.2	9.4	1.9	7.6	0.1	9.0	1.3
Korea	16.2	6.8	9.0	0.2	9.1	3.9	5.1	0.1	7.2	1.9
New Zealand	18.1									
Austria	24.7	7.7	12.6	4.4	12.2	2.8	5.7	3.7	11.7	2.3
Belgium	17.2	10.1	5.6	0.9	5.4	2.5	2.0	0.3	4.8	2.0
Czech Republic	24.9	9.3	8.4	5.3	17.0	4.5	6.5	5.2	15.7	2.7
Denmark	28.3	8.7	19.3	0.3	10.6	3.3	7.2	0.1	10.0	2.8
Finland	25.6	8.6	18.8	1.5	9.6	4.2	7.4	1.2	9.0	3.6
France	23.1	11.0	7.3	4.7	9.1	3.2	4.2	1.6	7.6	1.8
Germany	17.8	2.9	13.8	1.1	7.3	1.5	5.4	0.4	6.7	0.8
Greece	18.6	13.0	1.6	3.2	7.3	4.3	0.8	1.3	6.7	3.8
Hungary	29.8	13.5	13.8	2.2	18.3	8.6	7.4	2.1	16.8	7.0
Iceland	25.8	14.0	8.2	2.7	12.9	4.8	5.1	2.1	11.8	3.6
Ireland	20.8	8.7	11.7	0.3	10.1	2.7	7.1	0.1	9.9	2.6
Italy	20.0	10.0	9.7	0.7	8.0	2.7	4.9	0.4	7.4	2.1
Netherlands	18.7	7.7	10.2	0.9	9.0	3.7	4.9	0.4	8.0	2.7
Norway	25.4	9.6	16.1	0.0	11.4	5.6	6.1		9.7	3.8
Poland	22.6									
Portugal	21.0	16.4	4.4	0.5	7.2	4.8	2.6	0.1	6.2	3.8
Slovak Republic	25.1	18.1	3.7	3.3	15.3	9.5	2.8	3.0	14.1	8.2
Spain	20.5	7.1	8.9	4.5	8.7	2.6	4.4	1.6	8.1	2.0
Sweden	33.2	10.7	23.1	0.0	14.6	6.3	9.0	0.0	13.0	4.7
Switzerland	19.6	3.4	15.7	0.3	8.6	2.1	6.2	0.1	8.0	1.5
Turkey	17.7	14.8	2.1	0.0	7.5	5.6	1.1		6.8	5.0
United Kingdom	25.2	14.6	9.7	0.2	13.1	9.0	3.3	0.1	10.0	5.9
<b>OECD simple average</b>	22.2	9.8	11.0	1.7	10.3	4.2	5.2	1.1	9.2	3.1
<b>OECD weighted average</b>	20.0	7.1	12.1	1.2	9.2	3.4	5.4	0.5	7.6	1.8
<b>EU weighted average</b>	21.5	8.9	10.8	1.8	9.2	3.8	4.7	0.7	8.0	2.5

Note: These ratios were calculated on the basis of data submitted by OECD member countries. The Observation year differs between the individual countries. Estimates were made for missing national data. Please refer to assumptions and methods used in the source.

Source: Audet (2002).

### *Competition in publicly funded services*

Public procurement is a substantial part of the economy, with one of the highest ratios of public procurement to GDP at close to 30 per cent against an OECD average of 20 per cent (**Table 6**).<sup>60</sup> Hungary has been one of the first countries to set-up an independent public procurement council (*Közbeszerzések Tanácsa*), comprising members from the national competition authority (representing “public interest”), purchasers and suppliers (18 members in total). The Council issues a weekly journal that contains procurement tender invitations and guidelines. There is also an independent body handling appeals and complaints on procurement (the Procurement Arbitration Committee). About 80 per cent of the advertised procurement is made through open bids (alternatives are invitation and negotiated bids). While this structure is commendable, the ratio of advertised procurement to total procurement of about 16 per cent is about the same as the European Union average (see *Közbeszerzes, 2003*, and *OECD Economic Survey of the Euro Area 2003*).

Exemption from tendering rules, notably for utility companies and large-scale public works, has undoubtedly contributed to some of the widely published instances of unscrupulous behaviour in the tendering and management of public sector contracts. Notably scandal surrounding motorway construction led to amendments in the tendering rules for this activity in July 2002.<sup>61</sup> Generally, information on the winning bid is not publicly available and fines for misconduct arguably remain too low (OECD, 2002). Further, some observers argue that there are other problems in public procurement, *inter alia* lack of control regarding fulfilment of contracts, lack of supervision of relations between contractor and sub-contractor, weak regulation of cases of combined interests between purchaser and provider, and lack of legal competence in pre-qualification assessment (Open Society Institute, 2002). In addition, off-budget procurement through, *inter alia*, the Hungarian Development Bank and the State Privatisation Agency (APV), has been a cause for concern in the past. However, recent changes to these institutions appear to have reduced this problem. Public procurement rules also feature among the complaints of foreign investors along with other aspects of red-tape.

Following rather mixed experiences in the 1990s, arrangements for public-private partnerships (PPPs) are now being further developed. One of the first motorway concessions arrangements, the building of the motorway between the Austrian border and Gyor, had to be re-nationalised in 1999. A major problem was that projects were not sufficiently submitted to competitive pressures. In other cases, the government had (implicitly or explicitly) underwritten the projects, and ended up bailing them out. Within the framework of recent efforts to introduce PPPs an inter-ministerial PPP committee was set up in June 2003, comprising the Prime Minister’s Office, the Ministry of Economy and Transport, the Finance Ministry, the Justice Ministry and the Central Statistics Office. This committee has been working on establishing a new legal and administrative framework for PPP projects. The establishment of a clear framework would be welcome and should be combined with building

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60. Audet (2002) estimates that one third of total public procurement (consumption and investment) is potentially open to international trade. In most Member countries, procurement by sub-central government is larger than procurement by central government by about two to three times, but in Hungary this split is even. The Hungarian overall ranking in the OECD is stable, whether measured as total expenditure (consumption and investment), as total expenditure less compensation, or as total expenditure less compensation and defence.

61. Problems with motorway construction began with severe conflicts of interest. The construction projects were not subject to standard public procurement procedures and the sub-contracts were severely criticised. The new government has brought motorway construction under public procurement rules. However, even since then, these construction projects have been criticised for cost overruns, as well as for other problems.

experience, through both small projects in various sectors (*e.g.* prisons, student hostels, cultural centres, *etc.*) and large infrastructure works.

### **Conclusion**

Hungary has made considerable progress in establishing competitive markets, especially considering its starting position in the early 1990s. It has liberalised a considerable number of markets and differs very little from other OECD countries in terms of broad measures of competition. Indeed, there are no grounds for concern about widespread monopoly or cartel practices and the government has not sheltered industry through standard protectionist measures. However, it is clear that problems remain in specific sectors. In particular, the reform of network industries has been sluggish in some important respects. The small size and low productivity of much of Hungarian industry also implies low exposure to forces of change, through competition or other means. **Box 2** summarises the policy recommendations that would help to resolve these issues.

## Box 2. Recommendations to enhance competition

**Competition legislation and enforcement**

- Introduce the **right of individuals** to enforce Hungarian competition law before the courts. This would avoid differences between EU and Hungarian competition laws that could result in unnecessary jurisdictional disputes. Such a move could also free up some capacity for the GVH by reducing the number of individual complaints.
- Consider introducing **sanctions** against individuals as a mean of increasing the power of competition law to deter hard-core cartels.
- Create a separate unit within the GVH for **consumer fraud** cases. This would make case-handlers more productive by allowing them to specialize and would make enforcement of competition and consumer fraud cases more effective.
- Transfer the rate setting authority in the area of **cable television** to a regulatory authority, such as the telecommunications regulator. This would relieve the GVH from a large number of excessive-price cases that require significant resources and are difficult to win with competition law instruments.
- Introduce a number of **procedural reforms**: *i)* accelerate decision making, particularly in merger cases that do not raise substantial competition concerns; *ii)* review the monetary notification thresholds to ensure that small transactions that are unlikely to create competitive harm are not subject to a notification requirement; *iii)* review the time allowed for cartel investigations; and *iv)* give the GVH greater flexibility to deal with individual complaints by extending the statutory review periods, or by increasing the GVH's discretion to open a full investigation following a complaint (preferably accompanied by a right of individuals to enforce Hungarian competition law before the courts).

**Regulation policy in network industries: general recommendations**

- Increase the strength and efficiency of **industry regulators**: *i)* insulate their decisions (particularly pricing decisions) from political and budgetary interference and capture by interest groups; *ii)* modernize the regulatory institutions by ensuring that they make their decisions based on market information rather than technical regulation.
- Phase out the maintenance of low regulated **retail prices for households** in gas and electricity, and allow the retail price to reflect market rates. This would be helped by making regulators more independent. Answer welfare concerns by alternative means.
- Further reduce the role of government in determining **network access charges**. Again, a more independent role for the regulator would help in this regard.
- Continue to reduce the size of **government shareholdings**, and remove some of the preferential rules on the shareholding
- Strengthen the independence of **network operators** in particular in the electricity and gas sectors.

**Regulatory policy in network industries: sector-specific recommendations**

- **Electricity**. Monitor long-term contracts and take steps to dismantle them if they are preventing effective markets from developing. Increase connection to the international grid so as to increase the capacity for competition.
- **Gas sector**. Assess the gains from reducing vertical integration through the break up of MOL. Facilitate the installation of additional storage facilities.
- **Telecommunications sector**. Reduce the power of the incumbent, particularly in fixed-line services, by better enforcement of competition legislation in carrier selection, prices squeezes and interconnection fees. Encourage the development of competing networks, for example by introducing radio spectrum licences for 3-G phone networks.
- **Rail services**. Advance further towards privatisation and liberalisation, *inter alia* introduce a fully independent network operator, and set-up mechanisms to allow competition on train operation.
- **Postal services**. Address more rigorously the problem of over-staffing and non-viable rural post offices.

**Regulatory policy in competitive industries**

- **Retailing**. Abandon the policy of regulated minimum prices for certain food products.
- **Professional services**. Reduce entry restrictions and price-setting by chambers. Allow competition law to operate in the professions with less overriding legislation.

**Subsidies and state aid**

- Bring fiscal aid in line with EU recommendations.
- Engage in more comprehensive evaluation of the costs and potential benefits of subsidy and aid programmes.

**Public procurement**

- Strengthen the tendering process with the aim of moving provision away from incumbent providers, particularly in local and regional government.

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