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INDUSTRIAL FINANCING OF MANUFACTURING ENTERPRISES IN HUNGARY 1/

by

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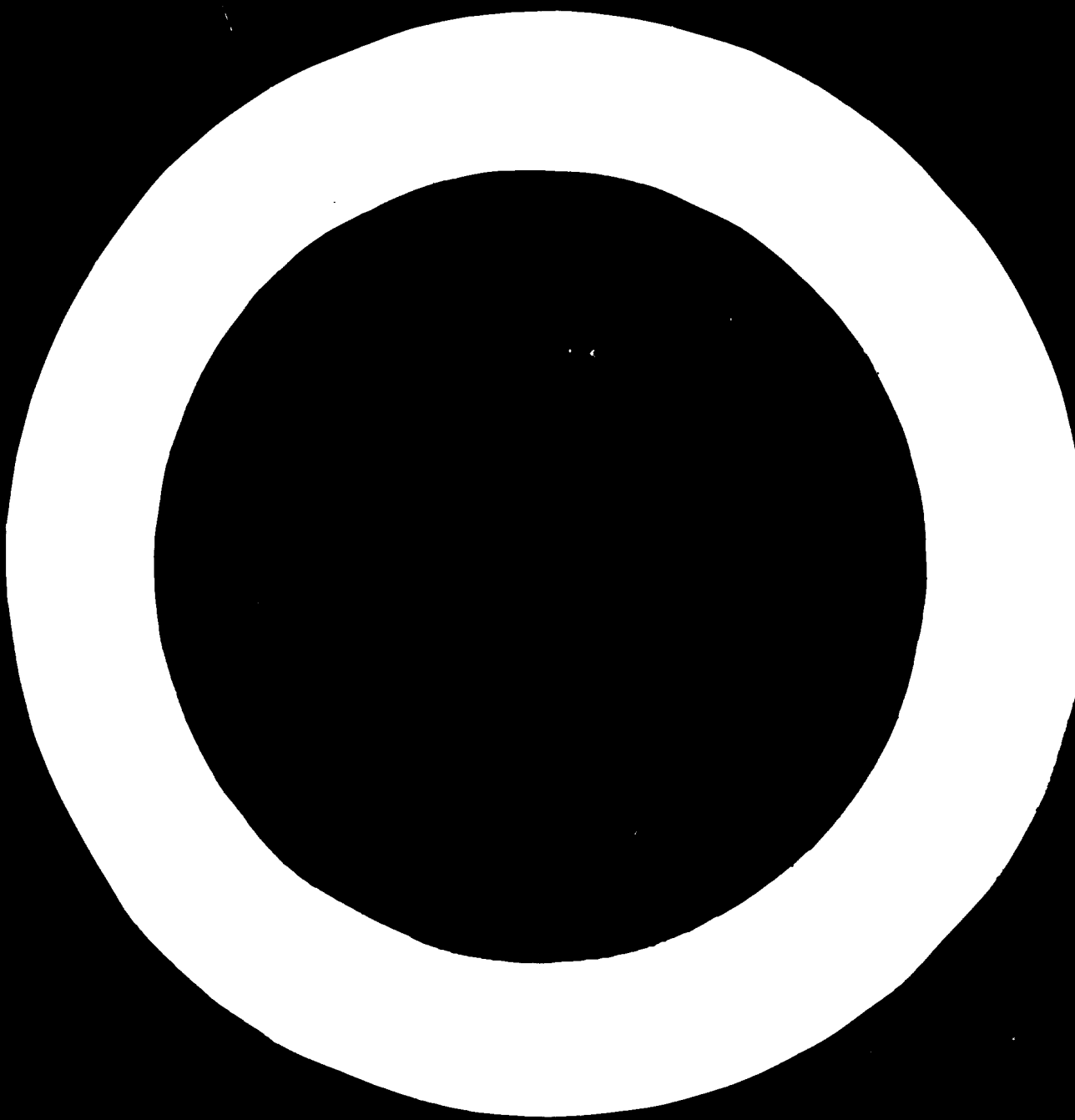

INDUSTRIAL FINANCING OF MANUFACTURING ENTERPRISES IN HUNGARY

A Financing Aspects

I Introduction

There are two types of manufacturing enterprises in Hungary: state-owned enterprises and co-operatives. Private sector exists only in the small-scale industry - mainly handicrafts. The state-owned enterprises are largely directed by central ministries, and a minor part, by local authorities. The distribution of the manufacturing enterprises of these types according to the number of enterprises, number of total employees and gross value of fixed assets was on 1 January 1968 as follows:

	Number of enterprises	Number of total employees (in 1000's)	Gross value of fixed assets (in 10^9 Ft's)
State-owned enterprises total	48	85	99
directed by (i) ministries	129	76	95
(ii) local authorities	19	9	4
Co-operatives	52	15	1
All enterprises (Absolute figures)	100 (1509)	100 (1462)	100 (183)

The co-operatives have significant role only in light industry, in heavy industry the overwhelming part of the enterprises is state-owned. Since the major part of manufacturing investments will be absorbed by the sectors of heavy industry, manufacturing investments in Hungary will be realized primarily in and by state-owned enterprises.

Manufacturing production in Hungary from 1950 increased annual at an average rate of 10 per cent, national income at 5 per cent. Thus, the share of manufacturing in the Hungarian national income has been doubled, in accordance with the government's policy of industrialization. As for labour, the growth of manufacturing production may be attributed to the increase of employment and labour productivity, output per employee, approximately by fifty-fifty per cent. The gross value of fixed assets increased by about the same rate as output, thus the average capital/output ratio did not change significantly.

In order to foster the process of industrialization and the growth of manufacturing the government's investment policy had to create a great number of new working places in manufacturing and only limited resources could be devoted to the modernization of existing establishments. From the sixties, however, an increasing emphasis has been given to help the dominance of intensive vs. extensive development which has its consequences also for investment policy.

Until 1968 productive investments for public manufacturing enterprises were distributed in general in the form of budgetary grants, other financial sources, i.e. credits, internal savings, had no significant role. With the aim to stimulate the better utilization of fixed assets and to limit the enterprises' requests for investment funds, a levy of 5 per cent on fixed assets was introduced in 1964.

On 1 January of 1968 a reform, a new system of economic guidance, was introduced in Hungary aiming at the acceleration of technical progress and economic growth, the increase of efficiency of enterprises' operation and not the least the improvement of allocation of resources, i.e. investments.1 The new system reserved the idea of central planning but combined it with a regulated function of the socialist market. Enterprise profits and market effects became important incentives but within the framework of an elaborated system of partly economic (mainly financial) and partly administrative regulators (with the preponderance of the former), that would channel the activity of all economic units towards the implementation of the major objectives laid down in the national economic plan.

This reform of the so-called economic mechanism modified both the financing of manufacturing investments and the tasks and responsibilities of government investment policy. The major features of these changes are decentralization of investment decisions and a wide-range use of indirect measures in order to influence the firms' decisions. The government's investment policy has also the new task to control and balance the market for investment goods and activities. The following paragraphs deal with the regulations and practice in accordance with this new situation.

II Sources of Finance

In the financing of public manufacturing enterprises in Hungary domestic sources play a predominant role, external sources being of minor importance. As for domestic sources, government and internal channels are used. Private savings are handled by the state-owned bank-system and can be mobilized by public manufacturing enterprises only through government channels. In 1968 out of total

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1/ For more detailed information see "Reform of the Economic Mechanism in Hungary" Nine studies. Ed. by Istvan Friss. Budapest, 1969. 274 pp.

investment expenditure about 60 per cent went through government, 40 per cent through internal channels.

1. Domestic sources

(i) Government Channels

The new system of financing public manufacturing enterprises was stated in accordance with the policy of decentralization of economic decisions, in particular that of investment decisions. The idea was that investments which can be decided best by state authorities are to be financed primarily from government funds; investments which can be evaluated and determined better by the enterprises themselves, must be financed from internal funds, although these internal funds may be supplemented by government credits.

Through government channels investments may be financed in the form of

- budgetary appropriations,
- state loans, and
- state credits.

Investments decided by state authorities will be financed in general either by budgetary appropriations or by state loans; investments decided by enterprises will be financed by internal funds and state credits. 2/ Though these forms of financing differ from each other in many respects, several regulations approximately equalize their final consequences on enterprise profits and bring their users in a similar position; the same time they create the conditions for rational choice and equal interest in the economic use of all these sources.

2/ Some explantory notes on the centralised Hungarian system of banks will be in place. Two banks are of great importance in this context: the National Bank of Hungary and the Hungarian Investment Bank, (there is also a bank for foreign trade and one for handling private savings and loans). The National Bank directly instructed by the government keeps the current accounts of all economic and budget organizations, accepts interest-bearing deposits from enterprises when they can spare temporarily some of their financial means and grant credits for circulation purposes; it is the central agency of foreign exchange monopoly as well. The Investment Bank deals with investment credit (for construction enterprises both circulating and investment).

The investments to be decided upon by state authorities and thus financed by budgetary appropriations and/or state loans include two major groups.[3]

(i) the so-called *individual projects having important influences on the structure and rate of growth of the whole economy or its major sectors and

(ii) lump sums for investment allocated to objectives where the concrete individual investment serving the same objective and as a rule being of similar character can be decided upon by subordinate state authorities or by the interested enterprises themselves.

The large individual projects may have both productive and infrastructural character and in the first category they may be establishment of new plants or major reconstructions and enlargements of exisiting ones. Qualification depends partly on the costs of the projects, partly on their characteristics and impacts on the structure and growth of the economy; their implementation enjoys priority. In 1968 about one hundred large individual projects were approved, including both productive and non-productive investments.

The lump sums for investment allocated to objectives are also of great importance for the total economy or for its major sectors. They serve, however, not the implementation of defined single projects but a great number of similar minor investments common in their location, mostly in different geographical areas, often interrelated e.g. housing, production and distribution of energy, development of the network of highways, etc.. In manufacturing this group of investments is of less significance.

The scope of enterprise decisions covers the investments deemed necessary for its own development, primarily the maintenance of the capacity of fixed assets, as well as their continuous modernization, flexible adaptation to the market, improvement of product range and quality, and further on capacity expansion. These investments are to be realized from internal sources supplemented by state credits.

3/ There is a third minor group of smaller, non-productive projects of local importance.

Thus, the major types of investments and their financial sources in Hungarian manufacturing may be illustrated as follows:

Type of investment \ Financial sources	Budgetary appropriation	State loan	State credit	Internal sources of enterprises
	Government channels			
Large individual projects for i new plants iiexisting plants	X X	X X	X	X
Lump sums for investment allocated to objectives		X	X	X
Investments within the scope of enterprise decisions			X	X

From the three types of government channels indicated above budgetary appropriations may be allocated both to new enterprises founded by state decisions and to existing enterprises for major reconstruction or capacity expansions. In both cases the decision must be taken by state authorities and approved as a large individual project. Lump sums for investment allocated to productive objectives will be financed by the government only in the form of loans, budgetary appropriations can not be used. In case of existing manufacturing enterprises also for large individual projects budgetary appropriation is given only exceptionally, financing being effected by state loans and internal sources.

State loans may finance both new enterprises or existing ones strictly defined in any case either as large individual projects or "allocation to objectives". The approval by state authorities include also a special regulation concerning the terms of repayment by the prospective user. These loans differ from the usual bank credits in the sense that their period of payment and rate of interest are fixed by a special contract between the government and the user.

The financial sources of the repayment are depreciation allowance and profits transferred into the development fund of the enterprise. 4/ In the case of new establishments these may be calculated easily, but in that of existing enterprises they must be calculated and handled separately from fixed assets already in use.

4/ The profits of the enterprise are to be split up into two parts: development fund and sharing fund, after a deduction of taxes of different rates. For further details see (iii) Internal Channels.

State loans as a rule must be repaid within ten years; the starting year of repayment and the rate of interest are fixed, too. Where the sources of repayment mentioned above are not sufficient within the 10-year limit, budgetary appropriations are provided.

State credits may be a complementary part of financing enterprise investments in addition to the enterprise's development fund which are offered as security and constitutes the source of repayment. The principles of credits are summed up in the "Directives of Credit Policy" approved by the government in harmony with the national economic plan. Investments may be financed by medium-and long-term credits. Medium-term credits are to be repaid within 3 years and long-term credits within 6 years. The condition of granting investment credits for medium-term is credit worthiness; for long-term it is both credit worthiness and a prescribed minimum level of profitability of the investment. Claims for long-term credits meeting this requirement compete with each other. They are evaluated and ranked primarily by profitability and term of repayment offered but preferences are also taken into consideration. In the selection, preference is given to investments which seem to promote the objectives formulated in the plan and which are more profitable, and also give promise of shorter period of recoupment. Both state loans and credits for investments can be given only by the Hungarian Bank of Investment.

(ii) Private Sector Channels

Private savings cannot finance directly public investments. Private savings and loans are handled by a special bank and the surplus, if any, will be absorbed by the national budget and mobilized for investment purposes only through the Hungarian Bank of Investment.

(iii) Internal Channels

The profit of the enterprises is equal to the sales receipts, less costs including a 5 per cent levy on fixed and current assets and a 25 per cent charge on wage costs. 5/ These two items may be considered also as minimum charges on net incomes that any enterprise must pay. Beside these general contributions to be paid by all enterprises, there are special turnover taxes and subsidies, customs duties, and production taxes to absorb differential rents arising from extraordinarily favourable conditions of production.

5/ 8 per cent wage-tax + 17 per cent social insurance contribution paid by the enterprise.

Profits are to be divided into two parts and these two parts are again taxed separately and at different rates. The amounts after the deduction of these profit-taxes form a part of the development and sharing fund. The former may serve as internal source for investments.

This splitting up of the profits is performed according to the proportion of assets and wages; but wages are multiplied by a coefficient, usually 4, in order to increase the weight of the wages. The part of the profits designated for the development fund will be linearly taxed, usually with minor exceptions, at a rate of 60 per cent. The part of the profits flowing into the sharing fund is progressively taxed in order to act against an exaggerated differentiation of personal incomes.

The development fund is separated from the depreciation allowances. The rates of depreciation are centrally determined on the basis of the gross value of fixed assets with a differentiation by categories of fixed assets and branches. Generally, but with some variations, 40 per cent of the calculated depreciation allowances are transferred to the state budget and 60 per cent is retained and added to the development fund.

In addition to the development and sharing fund the enterprise must form a reserve fund, for covering possible losses and risks to be taken in enterprise decisions. Ten per cent of both funds are to be put into the reserve fund until this reaches a definite amount; the part from the reserve fund is repaid subsequently into the corresponding funds which serve as temporary source of finance.

The enterprise has to finance from its development fund first its needs for increasing current assets, secondly, its requirements for investments aim at both replacement, modernization and expansion of capacity. The development fund may be supplemented by credits to be repaid later on even from this fund. A transfer between development and sharing funds are not permitted.

2. External sources

External sources for investments in public manufacturing enterprises are used increasingly in Hungary but they still have a very moderate role compared to domestic sources. It is nonetheless not easy to outline the general features of the Hungarian practice since each case is treated individually according to a special agreement. Agreements with international financial institutions e.g. with the Bank of CMEA, Council of Mutual Economic Aid and bilateral arrangements are intended primarily to help the exploitation of natural resources and domestic patents, joint ventures to foster co-operation in production, technical progress and make use of advantages of international division of labour.

III Capital Cost and Criteria for Determination

1. Opportunity Cost of Government Grants and Subsidies

Since the mid-fifties, the elaboration and submission of efficiency calculations according to an officially prescribed standard system became a condition of approving state-financed investment projects in Hungary. This does not mean, however, that actual decisions were based predominantly on these calculations. According to this standard system, projects aiming at new capacities or capacity expansion, planned annual output or value added was set against planned annual operating costs plus 20 per cent of investment costs. This 20 per cent or the coefficient 0,2 was considered as a normal charge on capital or prescription of a standard period of recoupment, and later on interpreted also as the opportunity cost of capital, or the social marginal rate of substitution between labour and capital. The numerical value of this coefficient was widely discussed in Hungary and according to many economists the value of 0,2 was considered as being overestimated. The original - considerably simplified - calculations of its value started from the costs of substituting labour by capital, and later on some experiments were carried out by using mathematical programming methods. These computations yielded only marginal value.

In the new system of economic guidance in Hungary these types of efficiency calculations of investments are not obligatory, since the different types of investment, the different situations of decision-making and the different sources of financing require different calculations both from government authorities and from enterprise management. Nevertheless, there is a need for calculations taking into consideration the opportunity cost of capital from a national-social point of view. This due first of all to

granting budget appropriations and to a minor extent by fixing special conditions for state loans for important "large individual projects", though in all these cases decision-making has to take into account a great number of other considerations. Since scientific discussions did not succeed up till now to agree upon the proper value of this opportunity cost of capital, mostly a set of calculations will be performed by alternative values of opportunity cost, following the example of parametric programming methods. It must be stressed, however, that by the allocation of budget appropriations and state loans primarily prerequisites of balanced growth or planned imbalance accelerating economic growth dominate and calculations with opportunity cost of capital have considerable impact on actual decisions only in some cases.

2. Cost of Loan and Equity Capital

As explained above, in the new system of economic guidance in Hungary manufacturing enterprises participate in budget appropriations free of charge except where these appropriations maybe supplementedby financial sources from either state loans or state credits. In both cases they are obliged to repay the capital with interest, and the difference of these two types of financing consists just in the different terms of repayment and rates of interest. In case of loans these terms are determined individually, in case of credits they are fixed by general regulations. As a rule the conditions of state loans are more favourable than those of state credits. Accordingly, the cost of these loans and/or credits are different depending on the rate of interest to be paid. A somewhat lower interest can be calculated on equity capital since the rate of interest paid by the Bank, depending on the contractual date of repayment, is in general lower than loan and credit rates. All assets of the enterprises, both fixed and circulating, financed by any source, will be charged equally by a levy of 5 per cent of the gross value of the assets but this is a standard cost with no differentiation.

3. Cost of Retained Earnings

The Hungarian public manufacturing enterprises must accumulate their "retained earnings" to be used for future investments according to special regulations in their development funds. The amounts not mobilized of this fund may be deposited in the Bank and thus yield interest. The rate of interest of these deposits depends on the terms of their expiration but as a rule is less than the rate of interest to be paid for credits. These conditions stimulate investment activity from internal sources.

4. Comparative Advantages and Disadvantages of the Various Sources of Financing Public Manufacturing Enterprises

From the point of view of the investors, i.e. the enterprises there is a definite order of rank of the various sources of financing of investments. The most favourable source is by budget appropriations, then to use own sources, (development fund,) then to obtain state loan and finally, the most expensive source, to request for state credit. This order is valid as a rule concerning both the rate of interest and terms of repayment.

From the point of view of government authorities the financing from internal sources has the advantage that these sources must be created by the enterprises themselves, by their effort to increase efficiency and profits. The disadvantage of this form of financing may be that the use of these sources can be influenced only by indirect means, namely by regulations effecting, profits, the accumulation and utilization of the development funds. These regulators are considered however, efficient enough and there is an intention to increase the role of these internal channels.

From the point of view of government authorities the financing by credits has the advantage that the applications compete with each other which is an incentive for preparing better projects. While credits can be allocated to more promising opportunities, they attthe same time offer the possibility of following the priorities laid down centrally. State loans are given usually on basis of individual cases when the importance of the investment does not allow to leave it neither to the open competition for credit or - giving preference against projects with higher profitability and/or shorter period of repayment - the rigorous general conditions of crediting. This form of financing has the disadvantage of not having the control of competition, but it is the way to implement strategic, important projects needed to the planned structure and growth of the economy. It has the advantage against budget appropriations that the pressure and terms of repayments stimulate to more rapid and efficient implementation and utilization of the investment.

B Financial Planning and Operations of Public Manufacturing Enterprises

1. Introduction

The public manufacturing enterprises [7] in Hungary enjoy a wide autonomy in the new system of economic guidance. The director of an enterprise is nominated by the ministry of the given branch and he is given great authority and responsibility. He has the right and the duty to decide upon all substantial problems of the enterprise. He is supported and assisted by his deputies and staff and in exceptional cases by social organizations.

The ministries [8] act in the capacity of representing the state as the proprietor of the state-owned enterprises. They exercise the rights of supervision and auditing. They are however not authorised to give direct instructions to enterprises in planning production, employment, investment or in decision-making concerning problems of operational or strategic character, except those dealing with national defence and foreign trade obligations. In general they are bound even in such cases to compensate for eventual losses suffered as a result of such instructions.

The directors or better general directors of the Hungarian manufacturing enterprises have as a rule two or three deputies: one responsible for production and technical development and the other for business and commercial matters; where there is a third deputy the two latter activities are delegated separately between the second and third deputies. Personnel management belongs to the competence of the general director. The "technical" director and his staff are responsible for production, research and development and maintenance. The "economic" director is responsible as a rule for planning, accounting and finance and in many cases for work organization and remuneration. The "commercial" director has to provide for materials, for sales and recently marketing activities.

7/ Only state-owned enterprises will be dealt with here.

8/ The state-owned manufacturing enterprises are supervised by five ministries according to the following branches: metallurgy and engineering; chemical industry including mining and electricity; light industry; building materials, construction and urban development; food insustries and agriculture.

2. Planning and Forecasting Financial Requirements for New Industrial Enterprises

Financial requirements for new industrial enterprises are planned in two stages: first the value of fixed and current assets needed is calculated and then the sources of financing.

The value of fixed assets includes the actual costs of design, construction, machinery and equipment as well as the costs of installation. All these items may be taken from the detailed documentation of the project. The value of current assets includes inventories of materials, work in process, semi-finished and finished products, as well as liabilities and cash. To be able to forecast these items the annual output and the operating costs are to be calculated first. Then by help of coefficients related to annual output, annual costs of materials used etc., requirements in inventories of work in process, semi-finished and finished products, and materials may be estimated. The coefficients are chosen according to the planned rate of turnover of the inventories. Liabilities and cash are calculated either by empirical coefficients or by more detailed estimates according to items.

Sources of financing, fixed assets were dealt with in detail in previous paragraphs. First state loans are calculated taking into consideration how much the enterprise could provide from its development fund, the time period for repayment of loans rate at profit accumulation and depreciation allowances. The residual will be financed as a rule by budgetary appropriations. Current assets are financed in general through budgetary appropriations to the extent of 60-70 per cent and the remainder through short-term credits.

3. Analysis of Commercial and National Economic Profitability

Commercial profitability of investments is often evaluated in Hungarian enterprises by indicators of pay-back period. Total cost of the project is divided by gross earnings per annum: the ratio represents the number of years required for recompment of total investment expenditure. The popularity of this formula is due to the simplicity of its calculation. In addition, it has the advantage to concentrate on the near future and liquidity. The shortcomings of this method include lack of emphasis and clarity on the years after the recoupment, as well as the life-time of the project, level of profitability, etc.

Another method often used may be called the average return on investment, when average annual earnings of the project are related to total investment expenditures. This yardstick takes into account the life-time of the project but ignores the time pattern of the earnings. This shortcoming is eliminated by the increasingly used methods of discounted cash flow, where each year's earnings and expenditures are calculated separately and discounted to the same definite point of time. In the new system of economic guidance in Hungary not only are the importance of time pattern, interest rate and discounting acknowledged but the interest rate has a great role in practice as well. The practical application of this type of theoretically appropriate methods is, however, connected with a great number of practical problems, originating essentially from the uncertainty of the future. This is the major reason while simpler methods are often preferred.

The Hungarian Bank of Investment uses two indicators to compare competing applications for credit: pay-back period of the total investment and pay-back period offered by the applicant of the credit required. These yardsticks measure commercial profitability, from the point of view of the Bank. There is a need, however, to evaluate national economic profitability, particularly where state loans and budgetary appropriations are involved.

For a yardstick of national economic profitability Hungarian economists recommend various methods. E.g. the following formula has been used and calculated obligatorily for many years:

$$g_n = \frac{T}{M + A_g + A_i + L + \Delta\,(B+F+B_k)}$$

where g_n stands for national economic profitability, T = value of output at world market prices converted into domestic currency, M = wages; A_g = domestic materials used; A_i = imported materials used at world market prices converted into domestic currency; Δ = 0,20 = efficiency coefficient which may be interpreted also as opportunity cost of capital; L = investment expenditures of fixed assets, F of current assets and B_k of related investment expenditure (e.g. for the expansion of production of the materials needed by the new establishment).

This formula takes already into consideration that actual domestic prices do not characterize properly national economic earnings and costs and uses of "world market" and accounting prices: it uses world market prices to measure output and imported materials, accounting prices by the conversion of world market prices into domestic currency, as well as for measurement of capital cost, Δ Projects are nowadays often evaluated by these indicators. In many cases a set of indicators are analysed, thereby existing several aspects and impacts of the project from a national economic point of view (employment, productivity, foreign trade balance, linkages etc.). Discounted cash flow methods have recently been increasingly recommended and practised in these analyses combined with the use of accounting prices for labour, capital, foreign currency or even for major products and materials.

4. Cost, Pricing and Profit Policies for Public Manufacturing Enterprises

Public manufacturing enterprises in Hungary are primarily encouraged to increase their profits. Profits may be increased by

- increase of output,
- reduction of costs,
- modification of product mix, and
- increase of sales prices and reduction of purchasing prices.

Thus profit incentives stimulate cost reduction in general and in particular when other possibilities mentioned above are limited. A great number of methods of organized cost reduction are well-known and used by Hungarian enterprises but not on a sufficiently large scale. Efforts are being made both to strengthen stimulat and to spread up-to-date methods of cost reduction. Since average earnings and relative wage costs are not very high in Hungarian enterprises, the stimulus for wage cost saving and increasing productivity might not be strong enough. There is however a search for methods to overcome this problem.

As a part of the reform of the system of economic guidance introduced on January 1. 1968 a general price reform has also been carried out in Hungary. This reform meant both the introduction of new prices and an approach to a flexible price mechanism. All basic producer prices were recalculated and newly regulated in order to have relative prices better reflecting actual production costs and market relations. Aiming at a more complete accounting of production costs improved methods were elaborated and introduced for the calculation of depreciation allowances and for values of imported goods; taxation and budgetary subsidies were revised as well.

In harmony with the idea of the combination of central planning and control and market mechanism, the new price system is based on a mixed use of centrally fixed and free prices. More precisely, in manufacturing there are four types of producer prices: fixed, maximum, limited and free prices. Officially fixed prices are not permitted to move in either direction. Maximum prices must not exceed an officially stated level; limited prices may move within a prescribed margin, while free prices are completely in the competence of the enterprises themselves. The basic raw materials and intermediary goods have fixed prices but in the processing industries the majority of prices are free. Simultaneously with permitting more flexibility price analysis and control have been strengthened.

This partially flexible price mechanism means that enterprises may utilize the price movements both in case of sales and purchases in favour of increasing their profits, and for their own products they must formulate and implement a specific pricing policy. Pricing policy is a new task for the Hungarian enterprises since previously all producer prices were fixed by central authorities. Although the price reforms measures have been in operation only since 1968 the Hungarian enterprises have shown continued improvement in adapting the new methods required by the new situation. Direct costing is seemingly going to be widely adopted.

Personal incomes and further development of public manufacturing enterprises depend to a great extent upon enterprise profits in Hungary. Sharing fund and development fund are built up, from profits and these are the single source of the increase of personal incomes and the main source of investments. Enterprises are, therefore, interested in augmenting their profits and in utilizing every means possible for this purpose. Further detail about the conditions of their activity is explained in the following paragraphs.

5. Operational Efficiency and Incentives

Operational efficiency of enterprises is measured now in Hungary primarily by the amount of profits. Although, the sources of these profits, the enterprises' contribution to the implementation of the national economic plan, and other aspects of their activity are analysed and evaluated, incentives are tied up with profits. At the same time, in order to narrow the possible gap between efficiency and profitability, all economic regulators are shaped in the direction that profits should be realised only by efficient activities from a national economic point of view, and that profits might be considered as proper indicators of efficiency. In emergency cases central authorities may intervene and also administrative measures may be taken to correct enterprise's activity and profits but these cases are intended to be at a minimum.

Much was said in previous paragraphs to the effect that the major source of investments for existing enterprises is their development fund which stems from their profits and depreciation allowances according to special rules. That means that the growth and even the survival of enterprises depends to a great extent upon their operational efficiency as reflected by their profits. Here it may be explained briefly, how personal incomes are connected with profits. The regulations in operation throughout 1968 and 1969 as described, are being analysed by competent authorities so that their impact, advantages and disadvantages and necessary modifications may be adopted for the coming years.

As mentioned above, the enterprise has to split up its profits into two parts in weighted proportion of value of assets and wages. After taxation, one part of the gross profits flows into the development fund, and the second part into the sharing fund. On the sharing fund there is the progressive profit tax the rate of which rises from 0 to 70 per cent, while the scale is related to the wages. This may be illustrated by an example. Assuming part two of the profits (going into sharing fund) amounts to 200, and total wages amount to 800 million Ft's:-

A breakdown of the profits		Profit - tax		Residual
in per centage of the wages	million Ft's	rate in per centage	million Ft's	million Ft's
- 3%	24	0	0	24,0
4 - 5%	16	20%	3,2	12,8
6 - 7%	16	30%	4,8	11,2
8 - 9%	16	40%	6,4	9,6
10 -11%	16	50%	8,0	8,0
12 -13%	16	60%	9,6	6,4
13,-	96	70%	67,2	28,8
	200		99,2	100,8

The residual, after a payment of 10 per cent into the reserve fund, is put into the sharing fund. This sharing fund serves to cover (i) the increase of the wage level, (ii) the part of earnings other than wages i.e. profit-sharing, premia, rewards, innovation fees, etc, as well as (iii) benefits in kind for catering, kindergarten, recreation, etc. and enterprise contributions to the costs of social, cultural, welfare facilities. From the point of view of profit-sharing and risk-taking the employees of the enterprises are classified into three categories: (i) top-management, (ii) lower management, senior staff members, foremen (about 5-12 per cent of the total personnel) and (iii) all other employees (operatives, etc.). Category (i) may receive profit shares, on the average, up to 80 per cent of the total sum of their salaries; category (ii) up to 50 per cent, and category (iii) up to 1% per cent. When, however, the enterprise's activity does not result in profits but shows a loss (and this can not be covered from the reserve fund,) employees classified into categories (i) and (ii) have to contribute to cover this loss. In this case only 15 per cent of the salaries will be paid to employees classified into category (i), and 85 per cent to category (ii). While greater responsibility and risk-taking can be remunerated, risks affecting personal incomes can also be expected. The amount of profit-shares to be paid to individual employees is not restricted, the above limits are valid only for the three groups.

Annex

Case Study: Application for Investment Loan

(1) Objective: Expansion of capacity.
(2) Planned implementation: 1.1.1969 - 30.9. 1971.
(3) Total investment expenditure (see Table 1.):
23200 th.Ft's 9/
(4) Planned source of finance: state loan.
(5) Scheduling of requirements:

Year	Fixed Assets	Current Assets	Total
1969	6312		6312
1970	9810	1010	10820
1971	4538	1530	6068
Total	20660	2540	23200

(6) Repayment (see Table 2): 7 years, 31.12.1971 - 30.6.1978.
(7) Indicators

(i) Recoupment period = $\frac{\text{total investment expenditure}}{\text{profits and depreciation allowances}}$ =

$= \frac{23200}{12000 + 1033} = 1{,}8$ year

(ii) Rate of profitability = $\frac{\text{profits}}{\text{total investment expenditure}} \times 100 =$

$= \frac{12000}{23200} = 52\%$

9/ All items in thousand Forints

Table 1

Calculation of Financial Requirements

1000 Ft's

	1969	1970	1971	Total
Construction	800	1000	200	2000
Machinery, domestic	5200	8000	3000	16200
Machinery, imported	-	-	600	600
Other expenses	200	300	300	800
Fixed assets	6200	9300	4100	19600
5% levy on fixed assets x/	112	510	438	1060
Expenditure on fixed assets	6312	9810	4538	20660
Current assets xx/	-	1000	1500	2500
5% levy on current assets	-	10	30	40
Expenditure on current assets	-	1010	1530	2540
Total expenditure	6312	10820	6068	23200

x/ See Table 1/a

xx/ Calculation:

Average stock of materials	1000
Average stock of work in progress	1000
Average active debts	500
	2500

Table 1/a

Calculation of the levy on fixed assets

This 5 per cent levy on fixed assets must be paid from the beginning of the implementation of the project. It will be calculated by quartals in a value of (5:4) = 1.25 per cent, on the average value of the fixed assets invested (S_a) as an arithmetic average of the stock of the beginning (S_1) and the end (S_2) of the period.

1969	Quartal I.	Quartal II.	Quartal III.	Quartal IV.	Total
S_1	-	200	1000	4500	
S_2	200	1000	4500	6200	
S_a	200	600	2750	5350	
Levy	3	8	34	67	112
1970					
S_1	6200	8000	10000	12000	
S_2	8000	10000	12000	15500	
S_a	7100	9000	11000	13750	
Levy	89	112	137	172	510
1971					
S_1	15500	17500			
S_2	17500	19600			
S_a	16500	18550			
Levy	206	232			438
					1060

Table 2.

1000 Ft's

	1971 IV. quartal	1972	1973	1974	1975	1976	1977	1978 30.6
Fixed assets								
Loan at the beginning of the period	20660	21022	19577	16447	13098	9515	5681	1579
Interest (7 per cent)	362	1472	1370	1151	917	666	398	110
Amount to be repaid	21022	22494	20947	17598	14015	10181	6079	1689
Repayment	-	2917	4500	4500	4500	4500	4500	1689
Loan at the end of the period	21022	19577	16447	13098	9515	5681	1579	-
Current assets								
Loan at the beginning of the period	2540	1466						
Interest (7 per cent)	51	117						
Amount to be repaid	2591	1583						
Repayment	1125	1583						
Loan at the end of the period	1456	-						

Remark: At first the loan for current assets will be repaid. The amount available for repayment will be calculated as follows:

Planned sales revenue per annum		243.000
Planned costs	"	228.060
Planned profits	"	14.940
Assets		28.000
Wages (per annum)		5.000
Wage-coefficient		2

Part One of the profits
(to be transferred into the sharing fund)

$$\frac{2.5000}{2.5000 + 23200} \cdot 14940 = 4500$$

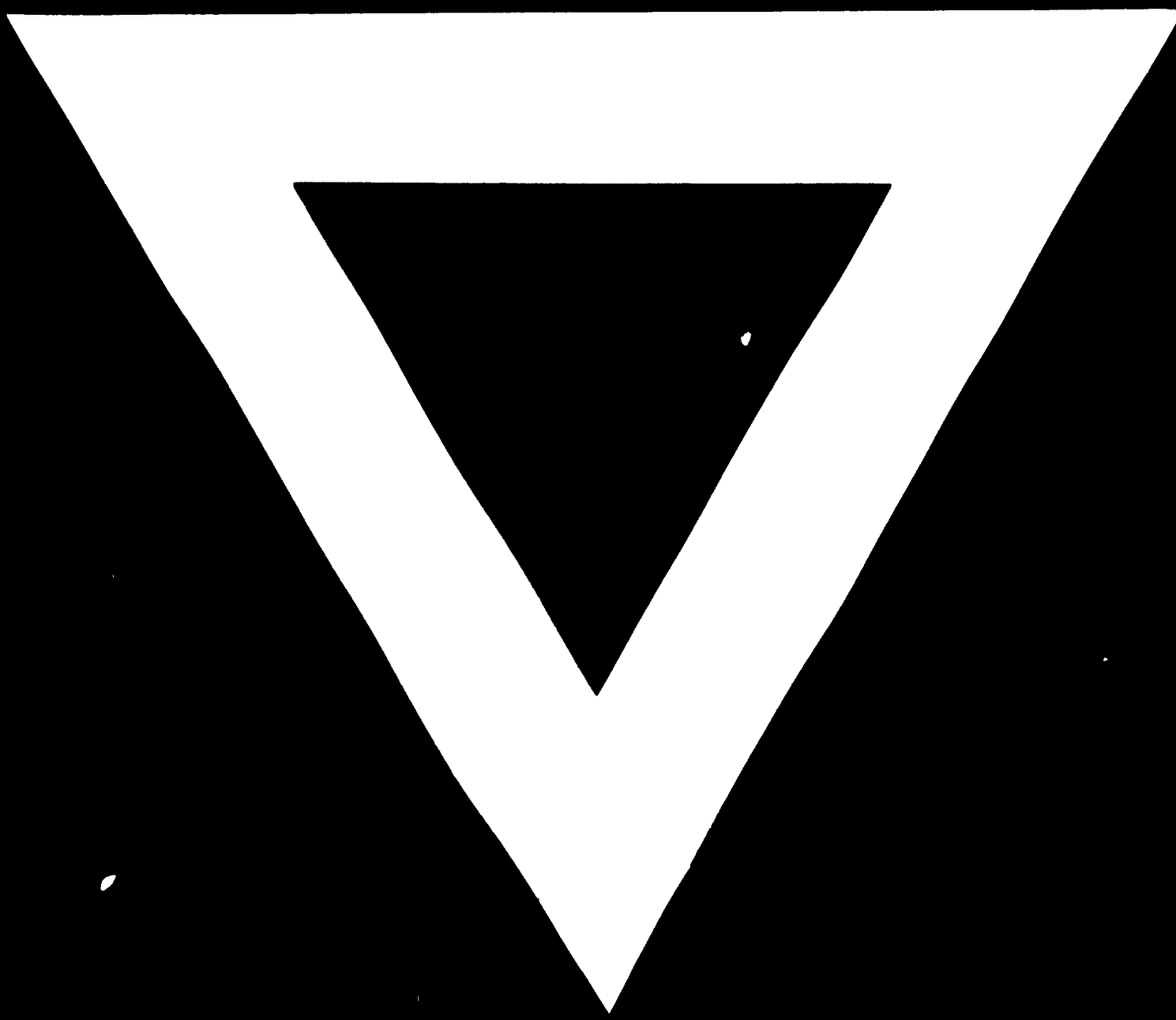
Part Two of the profits
(to be transferred into the development fund)

14940 - 4500 =	10440
Profit tax on Part Two (60 per cent)	6264
Residual	4176
Amount to be transferred into the reserve fund (10 per cent)	418
	3758

Depreciation allowances

7 per cent of the gross value of fixed assets	20660	1446
60 per cent from this to be transferred into the development fund		867

Development fund per annum	3758 + 867 = 4625	
Internal requirements "	125	
Available for repayment "	4500	
"	per quartal	1125



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