



## The transformation of Hungarian meat sector -lessons and experiences

I.né <sup>1</sup>Hajdu, Z. <sup>1</sup>Lakner, K. <sup>2</sup>Szerdahelyi

<sup>1</sup>University of Horticulture and Food Industry, Department of Food Industry  
Budapest, H-1118 Villányi út 35-43. Hungary

<sup>2</sup>Central Research Institute of Meat Industry, Budapest, H-1091 Gubacsi út 6/b. Hungary

### ABSTRACT

*The linkages between the privatisation of agricultural cooperatives, state-owned enterprises, their restructuring and the participation of foreign capital in both processes are the focus of this paper. In a broad sense, restructuring includes all policy measures and economic processes which increase the efficiency on an economy or of a company. The paper analyses the processes of privatisation and their effect on structure, conduct and strategy of various economic entities in the meat sector. The experience of last ten years puts us in a much stronger analytical position than at the start of the transition. In general it can be stated, that the privatisation of agriculture and food industry was a necessary precondition for improvement of economic competitiveness of meat sector, but did not solve numerous problems, and generated some important contradictions.*

(Keywords: privatisation, economic policy, strategic planning, vertical integration)

### ZUSAMMENFASSUNG

#### Umgestaltungen in der ungarischen Fleischwirtschaft - Erfahrungen und Versuche

I.né <sup>1</sup>Hajdu, Z. <sup>1</sup>Lakner, K. <sup>2</sup>Szerdahelyi

<sup>1</sup>Universität für Gartenbau und Lebensmittelindustrie, Lehrstuhl für Lebensmittelökonomie  
Budapest, H-1118 Villányi út 35-43. Ungarn

<sup>2</sup>Zentrale Forschungsinstitut für Fleischindustrie, Budapest, H-1091 Gubacsi út 6/b. Ungarn

*Ab Ende der 60-er bis Ende der 70-er Jahre war Ungarn in der Liberalisierung seiner Agrarpolitik weit über die in den übrigen sozialistischen Ländern gültigen Rahmenbedingungen hinausgegangen. Die ungarische Landwirtschaft war innerhalb des sozialistischen Lagers ein Vorzeigeobjekt und mit Abstand am leistungsfähigsten. Basis für diese Entwicklung war eine Zusammenarbeit zwischen den Großbetrieben und den Hauswirtschaften, die sogenannten Produktionssysteme. Diese Produktionsform war auf die konkreten ökonomischen und ökologischen Bedingungen abgestimmt und verfügte über einen sicheren Absatzmarkt. Durch das Privatisieren der Landwirtschaft wurden diese verschiedenen Formen der horizontalen und vertikalen Kooperation zerstört. Zeitlich dauerte jedoch der Strukturwandel länger als erwartet. Kapitalmangel und Unsicherheit führten bisher nicht zum erwarteten dauerhaften Aufschwung. Bei der Stabilisierung der Fleischwirtschaft spielten ausländische Direktinvestitionen eine wichtige Rolle. Die landwirtschaftlichen Kleinbetriebe werden jedoch auch in Zukunft weiterbestehen, da über 20% der Bevölkerung statistisch unterhalb des Existenzniveaus*

*lebt. Außerdem ermöglichen diese Betriebe als Nebenerwerb auf familiärer Basis die Fortführung der ungarischen Traditionen und des ungarischen Modells. Die wichtigsten Aufgaben in naher Zukunft sind: Verstärken der horizontalen Integration der Kleinbetriebe, Förderung der Konzentration und Verstärken der vertikalen Integration der Fleischverarbeitungsindustrie.*

(Schlüsselwörter: Privatisierung, Betriebsformen, horizontale und vertikale Integration)

## **OWNERSHIP AND STRUCTURAL CHANGES IN HUNGARIAN MEAT SECTOR BEFORE THE PRIVATISATION**

### **Historical background**

The recent development of Hungarian meat industry is hard to understand without a brief overview of recent development in Hungarian economy and society.

While collectivisation began in 1949, it was the military repression of the 1956 Hungarian revolution against the Soviet-style regime which prompted a quickening of agricultural collectivisation, completed by 1968, and tighter ties through COMECON. The theoretical aim of COMECON was the efficient division of production between socialist countries. In practice food and industrial products were transferred to the USSR in exchange for natural resources and technological inputs; the latter often out-dated technologies. The use of artificial exchange rates between the local currency (Hungarian Forint) and the Rouble resulted in low prices for Hungarian meat products which were supplemented with state subsidies and lead to poor product quality.

In the early 1970's problems of a growing foreign trade gap resulted in increased political emphasis on promoting exporting industries. By the mid-1980's a degree of economic liberalisation was already occurring with the introduction of a commercial banking system, tax reform and the abolition of consumer food price support. In 1989 the Hungarian Socialist Workers Party was removed from power in both the political arena and the work place, and privatisation and liberalisation began in earnest. The first free elections in Hungary for more than 40 years took place in 1990 and in 1991 COMECON itself collapsed. In agriculture privatisation of state farms began and price liberalisation was almost complete.

The process of transition to a market economy is not without its problems as demonstrated by the macro-economic indicators for Hungary during this period. In early 90s the GDP has fallen and the inflation rate reached 30%. High inflation followed the initial price liberalisation, and failure of the Government's attempts to stimulate the private sector through ill-conceived credit schemes lead to declining GDP. The budgetary controls introduced in 1995 - 9 per cent devaluation, import surcharges and control of energy prices - stabilised GDP but were initially inflationary. There now appears to be more stability with inflation in 1997 estimated at about 18 per cent and GDP annual growth at about 2 per cent.

### **The development of Hungarian agriculture and meat industry from collectivisation to privatisation**

After World War II Hungarian agriculture contributed some 38 per cent to GDP but had a highly fragmented structure in which more than 90 per cent of the farms were less than 12 hectares and a few large estates, which represented less than one per cent of farmers, held almost half of the land. This inequality was the target of land reform which after the Soviet-backed Communist Party gained power led to expropriation. Those estates of the so-called "gentry" between 58 and 580 hectares and those of

peasants above 145 hectares were redistributed and organised into co-operatives. Estates above 580 hectares were expropriated and turned into state farms. The latter were often badly organised but the income generated was diverted into industry by the state. The co-operatives also performed poorly and were dissolved after the 1956 revolution to be reorganised after 1957 in a second wave of collectivisation. In this programme state subsidies were used to encourage investment by the co-operatives and the development of joint marketing arrangements with the food processing sector. This was aided by the introduction of formal contracts for the sale of products with quality premiums and advance payments.

The land in the co-operatives remained in private ownership with about one-third of all land in actual state ownership. However in 1957 a law was passed under which ownership of that land held in the co-operatives by non-members was passed to the co-operative on payment of a sum equivalent to about 5-year's rent. As a consequence, by the end of the 1970's the private ownership of co-operative members had fallen to about 50 per cent. The comprehensive work of *Csizmadia* and *Székely* (1986) analyses the development of Hungarian agriculture and food industry before the reform-wave in end of 1980s`.

In the meat processing industry a large, centrally planned, state-owned company (trust) was established with no elements of a market economy, and farmers were obliged to hand over their produce to these state agencies, generally for prices below the costs of production. In the late fifties this system was replaced by formal legal contracts which protected the rights of the producers for a secure outlet but at a fair price, making the system in Hungary quite different in this respect from that in the other planned economies. The meat processing organisations also often assisted producer co-operatives in the purchase of machinery, and provided advice on production technology and product quality.

However after the partial economic reforms of 1968 the structure and organisation of the Hungarian meat industry gradually changed. The nation-wide state company was replaced with independent meat- industrial enterprises, more local factories, sometimes producer-owned. Central planning declined with more freedom given to processors in sourcing their raw material. This led to changes in the relative bargaining power of producers and processors depending on whether shortages or surpluses resulted from fluctuating annual yields. By the late 1980's it had become clear that the only real possibility for improvement was the adoption of a fully-fledged market economy system. Similarly in the retail sector, centralised organisation and severe diversion of income by the state into other industrial sectors had crippled the system.

Western commentators often use the term "command economy" to refer to the state organised agri-food industries in Central and Eastern European countries at this time. This is however an over simplification of a system in which, perhaps surprisingly, small private producers contributed significantly to meat production and were integrated with the large co-operatives. For example in 1980 more than half of pig production came from these small farms. Also the livestock feed was often produced on the co-operative and could be taken in lieu of wages by members who would then sell their livestock through the co-operative. There was also horizontal integration across the co-operatives which shared technical expertise and collaborated in marketing (*Szabó*, 1998).

## TRANSITION TO PRIVATE OWNERSHIP

### Agricultural transition

At the end of the 1980's it was clear that agricultural reform would be a major component of the transition to a market economy although different political parties had different views on how the land reform should be conducted. The elections of September 1990 saw the formation of a centre-right government which favoured the formation of a mixed agricultural structure based on family farms. To achieve this, account would be taken of the land ownership in 1947 before collectivisation, and compensation made where appropriate. People who were able to prove a legitimate claim were given a voucher which represented full compensation up to a value of about 2500 USD and a sliding scale of compensation thereafter. These vouchers could be used to purchase physical assets, which could include land (but only by the first recipient of the voucher), property, and also annuities. The purchase of the land could take place at auctions where the land price in 1991 averaged about 250 USD per hectare.

There were problems in this process of land restitution mainly arising from the separation of the land ownership and its use, due to the urbanisation of the population since the first half of the century. Although it is illegal for foreigners to buy land, farms in the north west of the country were acquired by Austrian farmers through local intermediaries. It is suggested that these Austrian farmers were subsequently setting aside land in Austria, producing in Hungary and "smuggling" the produce back across the border. The process of restitution was slow because of the lack of sophisticated information systems and this led to land actually falling into disuse.

Also, the division of large co-operatives and state farms often meant the separation of land from the associated farm buildings. This was the case in animal production. *The fodder basis of production were in separate ownership, than the pigstyes and cow-houses (Széles, 1993).* During this period the percentage of workers engaged in agriculture fell from 17 per cent in 1990 to 8.5 per cent in 1995 (Kocsondi, 1999).

Legislation was introduced to control the privatisation of co-operatives and allow members to leave with some assets. Some state farms remained in public ownership and others were privatised under the voucher system. The resulting changes in land ownership and holding structure are shown in *Tables 1 and 2.*

**Table 1**

### Land ownership in Hungary 1990 – 1998

Ownership(1)	1990	1991	1992	1993	1994	1998
			per cent			
State (2)	27	27	24	23	19	9
Co-op. (3)	64	62	57	42	38	30
Private (4)	7	11	19	35	43	61

Source: Central Hungarian Statistical Office. (*Quelle: Ungarisches Zentralamt für Statistik.*)

*Tabelle: 1. Tabelle: Struktur des Landbesitzes in Ungarn 1990 - 1998*

*Eigentümer(1), Staat(2), Genossenschaften(3), Privateigentum(4)*

**Table 2****Farm size structure in Hungary 1989, 1993 and 1994**

Size of holding ha (1)	1989	1993	1994
		No. Holdings (2) 000's	
< 500	46	634	972
501 - 3000	426	1153	1256
3001 - 10,000	934	567	29
Total (3)	1,499	2,395	2,572

Source: Central Hungarian Statistical Office (*Quelle: Zentrale Ungarische Statistische Amt*)

2. Tabelle: *Struktur der ungarischen Agrarbetriebe nach Größenklassen*

*Betriebgröße(1), Anzahl der Betriebe(2), Gesamt(3)*

These changes in the structure of production meant that produce was now being sold from a much larger number of small production units.

Many of the producers were former co-operative or state farm employees suddenly faced with new decisions about production and marketing. They often lacked the necessary technical and business skills as well as working capital. This latter situation has led to a reduction in the use of certain inputs such as fertilisers as well as a lack of investment and early sale of products in order to generate cash as interest rates rose.

The balance of power shifted in favour of the large meat processing organisations which were also able to source their raw material from abroad as imports were liberalised. Farm prices fell and consequently farm incomes did also.

### **Hungarian meat processing industry in transition**

Until the end of the so-called socialist system the economic environment of firms did not promote the efficient work of meat processing enterprises. The enterprises had to adjust to distorted prices. This was an extraordinary important problem in export-oriented industries, because these industries exported mainly in COMECON countries, and the prices of their products were determined politically. This system gave a wide freedom for Hungarian governmental organs to "compensate" these distortions by subsidies. Under these conditions the incentive to innovate in terms of new products and product quality was extensively weak. Thus the Hungarian firms followed a mixed strategy, according to various conditions of different market segments. The Hungarian meat industry produced for former Soviet member states low -quality mass- products with low value-added content, for markets of developed states high - quality products, and for domestic market middle quality products. The goal in forms socialists market was to achieve a high quantity, in markets of developed countries to maximise the gross income and in domestic market to maximise the net income.

The Hungarian meat industry exported extensively into EU - member states, and co-operated with leading European firms, so in this industry the demand-side incentives to improvement of production have been more expressed.

The collapse of COMECON and the privatisation of the predominantly state-owned firms caused a drastical change in firms` structure and strategy.

The main objective when privatising firms is to increase their productivity. There is an intense debate about the appropriate mechanism for privatisation, and the consequences of alternative approaches for economic performance. Many different mechanisms are under discussion. The standard approach used in past privatisations elsewhere in the world has been to sell shares of firms to the public (foreigners may or may not have been allowed to participate). This approach is inevitably very slow. The existing financial assets of domestic residents are tiny relative to the value of the firms to be privatised, based on rates of return in Western financial markets.

The increasing loss of balance of the budget and the severe management, marketing and financial problems of meat industrial enterprises underlined the importance of role of foreign capital in Hungarian privatisation. Contrary to the previous expectations, the foreign investors showed interest in the first place for industries

- with safe home market(e.g. tobacco ind.)
- single product lines ( e.g. sugar ind.)
- standard technology ( e.g. starch ind.)and
- mono- or oligopolistic position (e.g. brewery ind.).

The meat processing industry can be characterised by neither of statements above, that's why the foreign direct investments in this branch begun rather late.

The collapse of COMECON three main strategy types could be determined in the Hungarian meat processing sphere.

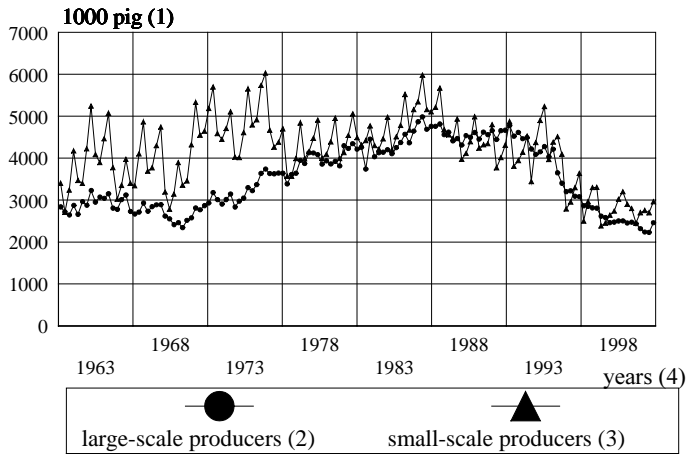
- the management does practically nothing, waits for possible ownership or market changes. In this case bankruptcy is practically unavoidable. In some enterprises the passivity of management resulted in a "melting away" of the material resources of the firm.
- the firm focuses on the home market, often with intensive product and/or process innovation . This strategy could be only a short-term solution , because the home market is approaching the saturation level.
- the management tries to take an active part in privatisation and -using existing connections with possible investors-does everything to stabilise the market positions of the firm.

After the long process of privatisation the Hungarian meat industry can be characterised by mixed ownership structure. The importance of foreign direct investment is increasing. This is of particular importance, because by this way is a possibility to involve capital for industrial modernisation and financing of revolving capital demand.

The change in farm structure, with the large increase in the number of small producers, has highlighted the concentration of the meat processing sector and led to calls from farmers' representatives for some desegregation of this sector with the aim of increasing competition. However, the meat processing sectors of EU countries show a degree of concentration very similar to that of Hungary. Although the causes of concentration differ (market forces in EU as against COMECON organisation in Hungary) the result is an industry which benefits from the available economies of scale, is well structured to support research, development and innovation, and can market produce efficiently. It can be argued that a policy aimed at reducing concentration in this sector may reduce efficiency as has happened in the meat processing sector. There, more than 500 small-scale plants have been established in the last 4 years, often with obsolete technology and poor hygiene standards, while at the same time the existing large plants are operating at only about 20 to 30 per cent capacity.

Fig. 1

The fluctuation of pig- number in small- and large scale production



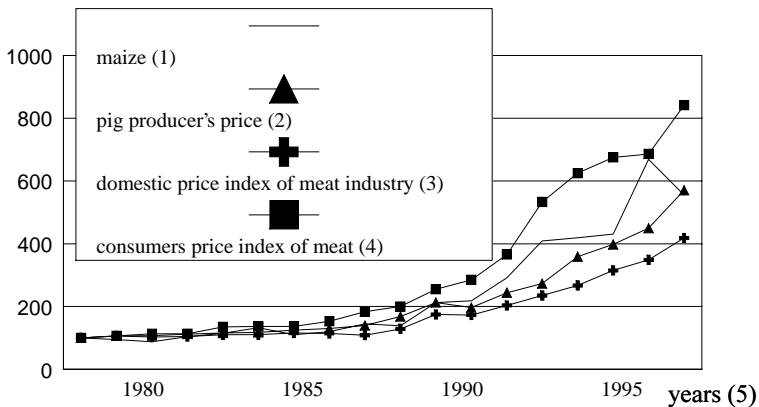
Source: Hungarian Statistical Yearbooks, own calculations. (Quelle: Verschiedene statistische Jahrbücher sowie eigene Berechnungen.)

1. Abbildung: Entwicklung der Schweinproduktion in Klein- und Großbetrieben

Stück(1), Großbetriebe(2), Kleinbetriebe(3), Jahre(4)

Fig. 2

The price indices in meat sector (1980=100%)



Source: Hungarian Statistical Yearbooks, own calculations. (Quelle: Verschiedene statistische Jahrbücher sowie eigene Berechnungen.)

2. Abbildung: Entwicklung der Preise in der Fleischwirtschaft

Mais(1), Erzeugerpreise für Schweinefleisch(2), Preisindex der Fleischindustrie(3), Verbraucherpreise bei Fleisch(4), Jahre(5)

The current fragmented farm structure also poses a major problem for the meat processing sector which prior to transition dealt with large scale co-operatives which ensured reasonably stable levels of supply of fairly uniform quality. Small producers are more volatile in their behaviour with wide and rapid swings in production in response to changing, often short term, prices (*Fig. 1*).

There is an increasing difference between in-and output prices of meat sector. By this way the income is pumped out of the sphere of production (*Fig. 2*).

One means of increasing the bargaining power of producers in the face of processor concentration might be for animal breeders to take a share in the ownership of processing facilities. In practice they have not had sufficient capital to do this and their political power is fragmented and has not led to policies which would enable this process. The only sustainable way of improving the balance in power between breeders and processors would be through the proper enforcement of effective competition law and reorganisation of the agricultural support system which currently channels the majority of support through processors or exporters rather than primary producers.

## **DISCUSSION**

The privatisation of Hungarian animal breeding and meat processing sector after more than 40 years of collectivisation has inevitably resulted in an industry of fragmented structure run by “new” entrepreneurs some of whom lack business skills and many of whom lack capital. As a result they are often working with outdated technology and in an environment where market information systems are still developing. The existing support policies are largely focused at the processor-exporter and of limited benefit to the producer. The producer sector has little market power being faced by a relatively concentrated processing sector which is flexible in its sourcing of raw materials and already includes significant inward investment.

The prospect of EU membership brings both opportunities and threats to the Hungarian animal breeding and meat industry. Improved market access for Hungarian quality meat to existing EU states and to the other new members will clearly benefit the sector. Although it is difficult to predict in detail the form of the EU support policy, it is likely that elements of it will still be farm based which would help the Hungarian producers. However, the capitalisation of this support into land values and any increased labour mobility will drive up overhead costs with a consequent loss of competitiveness.

Domestic policies should be aimed at improving agricultural productivity and increasing competitiveness in the meat processing sector. Animal breeding productivity improvements require training and extension programmes and better access to finance. Structural change needs the lubrication of an efficient land market and growth in the general economy to encourage labour mobility. Implementation of farm-based support and a stable system of intervention will ease the next transition - that of EU membership.

Improved productivity and farm structure, will go part way to addressing the problem of weak producer marketing power. The encouragement of producer involvement in the processing sector through co-operation and other new entrants, either domestic or foreign, would also improve competition. Finally, the proper enforcement of competition legislation would provide a suitable environment for these developments.



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Corresponding author (*Adresse*):

**Istvánné Hajdu**

University of Horticulture and Food Industry, Department of Food Industry  
H-1118 Budapest, Villányi út 35-43. Hungary  
*Universität für Gartenbau und Lebensmittelindustrie, Lehrstuhl der  
Lebensmittelökonomie  
H-1118 Budapest, Villányi út 35-43. Ungarn*  
Tel./Fax: 36-1-20-90-961  
e-mail: laknerz@hoya.kee.hu